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IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

ARCH C. SCURLOCK, ARTHUR W. SLOAN, JAMES M. JOHNSTON, MALCOLM F. SCHOEFFEL, FRANKLIN C. SALISBURY, and ATLANTIC RESEARCH CORPORATION, *Petitioners,*

v.

SAMUEL MELTZER, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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INDEX

	Page
Opinions Below	1
Jurisdiction	2
Question Presented	2
Regulations Involved	3
Concise Statement of the Case	3
Argument	6
Conclusion	10

Appendix	1a
Opinion of the District Court	1a
Order of the District Court	20a
Opinion of the United States Court of Appeals for the Fourth Circuit	22a
Judgment of the Court of Appeals	28a

TABLE OF CITATIONS

CASES:

Anderson v. Yungkau, 329 U.S. 482, 91 L.Ed. 2d 436, 67 S.Ct. 428 (1947)	9
Cold Metal Process Company v. United Engineering & Foundry Company, 351 U.S. 445, 100 L.Ed. 1311 (1956)	9
Delaware and Hudson Co. v. Albany and Susquehanna Railroad Co., 213 U.S. 435, 53 L.Ed. 862 (1909)	8
Hawes v. Oakland, 104 U.S. 450, 460-461, 26 L.Ed. 827, 832	6, 7
Johnson v. New York, New Haven & Hartford Railroad Company, 344 U.S. 48, 97 L.Ed. 77, 73 S.Ct. 125 (1952)	9

Page

LaBuy v. Howes Leather Co., 352 U.S. 249, 1 L.Ed. 2d 290 (1957), rel. den. 352 U.S. 919, 1 L.Ed. 2d 560 9
Levitan v. Stout, (D.C. W.D. Ky. 1951), 97 F. Supp. 105 8
McCullough v. Cosgrave, 309 U.S. 634, 84 L.Ed. 992, 60 S.Ct. 703 (1940) 10
National Equipment Rental v. Szukhent, U.S. , 11 L.Ed. 2d 354, 84 S.Ct. (1964) 9
Pomerantz v. Clark, (U.S. D.C. Mass. 1951 101 F. Supp. 341, 346) 7
United States v. Merz, U.S. , 11 L.Ed. 2d 629, 84 S.Ct. (1964) 9

STATUTES:

28 U.S.C. §§ 1254, 2101, 2106 2

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v.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Petitioners pray that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit entered in the above styled case on April 9, 1964.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fourth Circuit is reported in 330 F. 2d 946. The opinion of the United States District Court for

the Eastern District of Virginia is unreported. Both opinions are contained in the transcript of record certified to this Court by the Clerk of the United States Court of Appeals for the Fourth Circuit and as printed in the Appendix to this Petition.

JURISDICTION

The date of the judgment sought to be reviewed and the time of its entry is April 9, 1964. The date of the Order Denying Petition for Rehearing is May 20, 1964. The dates of the orders staying issuance of a certified copy of the said judgment in lieu of a mandate are May 26, 1964 and June 22, 1964. The terms of the respective orders granted such stay until June 25, 1964 and July 25, 1964. The statutory provisions believed to confer on this Court jurisdiction to review the judgment in question by Writ of Certiorari are 28 U.S.C. § 1254, 28 U.S.C. § 2101 and 28 U.S.C. § 2106.

QUESTION PRESENTED

The question presented for review is whether Rule 23(b) of the Rules of Civil Procedure for the United States District Courts in this case requires or permits dismissal of a stockholder's secondary action, where the stockholder made no prior demand for relief from the directors of the corporation, under the allegations of the pleadings, the testimony of the plaintiff* and evidence presented to the Trial Court by the plaintiff.

---

* The respondent, Meltzer, was the plaintiff in the District Court, petitioners were the defendants. Accordingly in this Petition defendants, appellees and petitioners are the same persons and plaintiff, appellant and respondent is the same person.

REGULATIONS INVOLVED

The prime regulation involved in this case is Rule 23(b) of the Rules of Civil Procedure for the United States District Courts. The pertinent portion of this Rule reads as follows:

> "Secondary action by Shareholder. In an action brought to enforce a secondary right on the part of one or more shareholders in an association, incorporated or unincorporated, because the association refuses to enforce rights which may properly be asserted by it, the complaint shall be verified by oath. . . . *The complaint shall also set forth with particularity efforts of the plaintiff to secure from the managing directors . . . such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort.*" (Italics supplied)

CONCISE STATEMENT OF THE CASE

This was a derivative stockholder's suit filed by the plaintiff* in the United States District Court for the Eastern District of Virginia. The jurisdiction of the Court was based on diversity of citizenship, the plaintiff being a citizen of New York and the defendants citizens of jurisdictions other than New York.

In his Amended Complaint plaintiff alleged that the personal defendants used funds of the corporate defendant (Atlantic) to purchase Atlantic's stock in order to protect their own personal investment, that the personal defendants benefited from these pur-

* An identical action was filed several days later by Herbert C. Sterenstein, Sarah Sterenstein and Joseph M. Newmark against Atlantic Research Corporation and other personal defendants including those in the instant case. Newmark was dismissed for failure to prosecute and the Sterensteins were dismissed at their request as parties to the appeal.

chases, that the personal defendants caused Atlantic to issue false financial statements and thereby sought to benefit themselves, that the personal defendants permitted Atlantic to finance other companies owned and managed by Atlantic's officers and employees, that defendants, Scurlock and Sloan, engaged in similar activities to their own benefit and to the loss of Atlantic. Plaintiff further alleged that demand upon the Board of Directors of Atlantic would be futile because the Board was controlled and dominated by the alleged wrongdoers (Scurlock and Sloan), that the Directors participated in the wrongs alleged, that the Directors negligently permitted the said wrongs to occur and that the institution of the derivative suit by the Directors would place the cause in hostile hands. (Appendix to Brief for Appellant, pp. 24a-31a).

Exhibit introduced by the plaintiff and affidavits attached to defendants' Motion showed the remedial action taken by the Directors before and during the time plaintiff's suit was being prepared. They removed Scurlock from his post as President and Chief Executive Officer of the Company, rescinded his power to commit corporate funds and even to draw checks, limited his authority to the normal operations of the business and required him to report to the Executive Committee. The Directors further obtained a guarantee of certain loans from the defendants, Scurlock and Sloan, took action respecting pledges securing bank loans, added two outside persons to the Board of Directors, set up an Executive Committee of three members including two outside directors, retained Price Waterhouse & Company as an independent accounting firm, selected an outside law firm as general counsel and authorized counsel to enter into a stipulation of facts with the Securities and Exchange Com-

mission contrary to the wishes of and over the objection of Scurlock. (Appendix to Brief for Appellant, pp. 24a-31a, Appendix to Brief for Appellee, pp. 5a-9a).

Information as to all these remedial steps was made available to the plaintiff after the hasty filing of his original Complaint on November 10, 1962, but well before the filing of his Amended Complaint on January 3, 1963.

The plaintiff himself, testifying through a pre-trial deposition, stated that he read the above report and that the report outlined the remedial action which the corporate defendant had taken. He was then asked if that was not the same remedial action he was requesting in his law suit, and he answered that he did not know, that he was not sure and that he did not pay too much attention to the report. (Appendix to Brief for Appellant, p. 20a, Appendix to Brief for Appellees, pp. 1a-4a, Appendix, *infra*, p. 16a).

After the filing of the pleadings, the taking of depositions and the filing of Memoranda of Authorities, the District Judge heard arguments on the defendants' Motion to Dismiss and rendered his opinion granting the Motion on May 29, 1963. (Appendix to Brief for Appellant, pp. 1a-23a). Meltzer appealed to the United States Court of Appeals for the Fourth Circuit, which Court reversed the judgment of the Trial Court and later denied appellees Petition for Rehearing. It is from the judgment of the Appellate Court that petitioner applies for this Writ of Certiorari.

ARGUMENT

Directly and concisely this case involves the vitality of Rule 23(b) of the Federal Rules of Civil Procedure. The decision of the District Court breathed life into the Rule. It upheld the spirit, the language and the purpose of the Rule. The decision of the Appellate Court killed the Rule. If the judgment of the Appellate Court were affirmed then Rule 23(b) might as well not have been put on the books.

The Rule provides that the plaintiff must set forth with particularity his efforts to secure from corporate directors such action as he desires. The remedy conferred upon him enabling him to file a derivative stockholders suit is an extraordinary remedy. To be entitled to this remedy a plaintiff must fulfill the requirements of the Rule.

Just as the privilege of bringing a derivative action is an extraordinary remedy, so the requirement of demand is a positive, constructive, preventive remedy. The purpose of the requirement of demand is to prevent litigation not to encourage it, to enable directors to settle their differences with stockholders before they go into Court, not to throw upon the Court the burden or upon the parties the expense, of asking a Judge to decide questions of fact that intelligent parties can decide between themselves. The requirement of demand envisages solutions not suits.

As stated by this Court in *Hawes* v. *Oakland*, 104 U.S. 450, 26 L. Ed. 827, "But, in addition to the existence of grievances which call for this kind of relief, it is equally important that . . . the shareholder . . . should show . . . that he has exhausted all the means within his reach to obtain, within the corporation it-

self, the redress of his grievances, or acton in conformity to his wishes." (104 U.S. 460-61, 26 L. Ed. 832).

"Here abides the ancient faith in the right of men to choose their own associates, make their own arrangements, govern themselves and thus grow in responsibility without much in the way of either hindrance or help from the state . . . Unsupported minority stockholder suits have been considered appropriate only where no fair forum except the Court was available." *Pomerantz* v. *Clark* (U.S.D.C. Mass. 1951, 101 F. Supp. 341, 346).

In the instant case the Directors of Atlantic Research Corporation did take remedial action. Perhaps they did not conceive of or perform all of the acts cited as possibilities by the Court of Appeals. But they did take action, dramatic action, effective action and more salutary action than has been taken in any case to which reference has been made in this litigation. As pointed out by the District Judge this case is unique in that the remedial activity was going on at the very time the plaintiff was preparing his suit. For that reason alone the necessity of demand is particularly important in the instant case.

Indeed it is significant that the plaintiff himself at the time of taking his deposition, long after the filing of his Amended Complaint, did not know what other remedial action he desired. As the District Judge pointed out, if the plaintiff did not know what further remedial action he wanted, it ill behooved him to come into Court and ask the Court to advise him. (Appendix, *infra*, p. 16a).

We repeat, in no other case cited by either party to this litigation has such effective and comprehensive remedial action been taken without any demand.

The presumption is that had demand been made and had specific remedies been suggested, they, too, would have been granted. The respondent made many averments of his own conclusions against all of the Directors besides Scurlock and Sloan. He did not make specific allegations of fact against these other Directors and he did not seek to charge them with misfeasance, rather he sought to catch them in a net-like charge of nonfeasance. Again the presumption would be that directors who were ignorant of impugned acts of other directors would be the first to remedy the alleged wrongs once they were called to their attention. An intelligent demand in the instant case would have brought the remedy and obviated the suit.

As the District Judge stated in his opinion, the question before the Court was not whether the Directors had given all the relief the plaintiff sought. The question is whether Rule 23(b) has been complied with and whether in the light of the evidence before the Court, the allegations of the Complaint were sufficient to excuse the demand. The Court felt that an aggregation of general conclusions did not justify the failure to make a demand. His decision was correct, because otherwise irresponsible averments of conclusions would nullify and destroy the usefulness of Rule 23(b).

The decision of the Court of Appeals for the Fourth Circuit in this case is contrary to the decision in *Levitan* v. *Stout* (D.C. W.D. Ky. 19..), 97 F. Supp. 105, and interprets erroneously the decision of this Court in *Delaware & Hudson Company* v. *Albany & Susquehanna Railroad Co.*, 213 U.S. 435, 53 L. Ed. 862 (1909). In the latter case involving the claim of one company against another with interlocking boards of directors, no remedial action had been taken and was not even foreseeable in view of the "unique" situation.

Moreover, the instant case involves an important question of Federal law which has not been, but should be settled by this Court. In this day of corporate activity important to the economy of the country and in the instant case important to the welfare of thousands of people within and beyond the boundaries of Virginia, it is essential that corporations be allowed to put their own houses in order before being thrown into the Courts by irresponsible or premature actions of minority stockholders.

This Court is a jealous guardian of the rules which it has promulgated for civil procedure in the United States District Courts. In numerous cases it has granted certiorari and has considered and defined the exact meaning of the Rules. For example see:

Rule 4(d)1. *National Equipment Rental* v. *Szukhent*, U.S. , 11 L. Ed. 2d 354, 84 S. Ct. (1964).

Rules 6(h) and 25(a). *Anderson* v. *Yungkau*, 329 U.S. 482, 91 L. Ed. 436, 67 S. Ct. 428 (1947).

Rule 50(b). *Johnson* v. *New York, New Haven & Hartford Railroad Company*, 344 U.S. 48, 97 L. Ed. 77, 73 S. Ct. 125 (1952).

Rule 53(b). *LaBuy* v. *Howes Leather Co.*, 352 U.S. 249, 1 L. Ed. 2d 290 (1957), rel. den. 352 U.S. 1019, 1 L. Ed. 2d 50.

Rule 54(b). *Cold Metal Process Company* v. *United Engineering & Foundry Company*, 351 U.S. 445, 100 L. Ed. 1311 (1956).

Rule 71A(h). *United States* v. *Merz*, U.S. , 11 L. Ed. 2d 629, 84 S. Ct. (1964).

Indeed this Court has held that the extraordinary remedy of mandamus lies for the purpose of compelling compliance with the Federal Rules of Civil Procedure. *McCullough* v. *Cosgrove*, 309 U.S. 634, 84 L. Ed. 992, 60 S. Ct. 703 (1940).

CONCLUSION

If Rule 23(b) means what it says and if as indicated above its spirit, its letter and its purpose are to be fulfilled, then this Court should reverse the judgment of the United States Court of Appeals for the Fourth Circuit and reinstate the judgment of the United States District Court for the Eastern District of Virginia.

Respectfully submitted,

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Alexandria, Virginia
July 20, 1964

APPENDIX

[1] **Opinion of the District Court**

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
ALEXANDRIA DIVISION

Civil Action No. 2787

SAMUEL MELTZER, *Plaintiff*,

v.

ARCH C. SCURLOCK, et al, *Defendants*.

Alexandria, Virginia
May 29, 1963

Before:

HONORABLE JOHN D. BUTZNER, JR.
United States District Judge

[2] Appearances:

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Counsel for Defendant Gerald T. Halpin

IRA P. BARSKY, ESQ. and
JAMES W. CROWLEY, ESQ.,
Counsel for Atlantic Research Corp.

---

[3] RULING OF THE COURT

The Court: Gentlemen, I first wish to thank you for the helpful way all of you have briefed and argued this case.

I think that there may be a few preliminary remarks before I take up the precise motions before us.

This is a derivative action, and the Court is fuliy in accord with plaintiff's counsel that the motives—as he expressed it—the motives of the parties do not of necessity destroy the action. The Court has considered it on the basis of the pleadings, and holds that merely because the plaintiffs wish to recover their loss, that it does not deprive it of its character of a derivative action. Therefore, all of my subsequent rulings are based on the holding, that we have before us a true derivative action.

Now, that does not mean to say that I have not considered their testimony. I have considered their testimony under the rule of Virginia—that a plaintiff's testimony should be accepted when he offers it, and it binds him. He can rise no higher than it.

We have a number of collateral motions. I think they can be disposed of very briefly.

[4] There has been a Motion to Dismiss on the ground that there is no jurisdiction because the subject matter is before the S. E. C. No authority has been cited to the Court on that, and the Court has found none. That motion is overruled. It appears that this action could be continued concurrently with the action before the S. E. C.

Probably the other collateral motion which should be disposed of at this time is that which was made generally in a number of ways; that is, an improper joinder of the defendants; that Atlantic should be the plaintiff.

In the present posture of this case, the Court believes that Atlantic has been properly joined as a defendant, and that this Court should not realign the parties, which would, of course, have the effect of defeating diversity and, consequently, jurisdiction. The Court believes that the case to which counsel have adverted, while not strictly in point, does set down the rules that governs the Court in this regard.

There have been various motions made that there is not the requisite jurisdictional amount. As counsel for both sides have very frankly stated, that is closely connected with the question of whether this is truly a class suit, a derivative action. The Court having found that it is a derivative action, the jurisdictional amount is present. The motion is denied.

[5] The two principal motions urged before the Court today are that the plaintiffs are not stockholders of record. That is admitted as a fact. It is urged that, consequently, they do not have status to bring this suit. Of course, that conclusion is vigorously opposed.

I considered some time during the morning that possibly it would be well to take this under advisement, write a memorandum on this point and on the point concerning the

demand. But I realize that from the standpoint of the parties, that time is important in this matter. You want to know where you stand. If there are appeals to be taken, they should promptly be taken. It seems to me that the most sensible thing to do under the circumstances is to express my opinions on these matters today, especially since they have been so well briefed and well argued by counsel.

Now, taking up the question of the status of the plaintiffs, there is no doubt that that is to be governed by Virginia law. *Gallup* v. *Caldwell*, 120 F. 2d 90 3rd Cir. (1941) considers this on page 93, where it said:

> "Does the applicable law require that the plaintiff be a stockholder of record? It is established that this plaintiff was not a registered shareholder, at the time the action was begun. The question is not [6] merely a procedural one, such as whether an action may be maintained by the real party in interest who is not the owner of a legal title"—citing Coodrich —"but the substantive one whether one who is not a shareholder of record may assert shareholder's rights either on behalf of or against the corporation. That is a question of the law of New Jersey, the state under the law of which this company was incorporated."

It is established here that this company was incorporated under Virginia law. Counsel advise the Court—I am sure you are correct—that Virginia has not passed upon this question. A stockholder or shareholder, as far as the Court could find, running through the definitions of the Virginia Corporation Act, was not defined as a stockholder of record, although there are many references in that act to a stockholder of record.

The Court understands that the majority rule in the United States is that the plaintiff in a derivative suit such as this need not be a stockholder of record. It is sufficient

if he has equity position. The case cited by the plaintiff, *Rosenthal* v. *Burry Biscuit Corporation*, 30 Del. Ch. 299; 16 A. 2d 106, 1948, commends itself to the Court on this rule. There Chancellor Harrington stated.

> "After an examination of the cases and a weight-
> [7] ing of what I consider to be the reasons behind the diverse opinions, I have concluded that the more reasonable view—which also appears to be the majority view—is one permitting an equitable owner to maintain a derivative action.
>
> "As this court pointed out in *Cantor* v. *Sachs*, 18 Del. Ch. 359; 172 A. 73, a stockholder's derivative suit possesses a double aspect. One aspect is the equivalent of a suit to compel the corporation to sue and the other is the suit by the corporation asserted by the stockholders in its behalf. The former belongs to the complaining stockholders while the latter belongs to the corporation. The action belonging to the corporation possesses the substantial ultimate interest since it involves the merits of the controversy. The interest of the corporation and the equitable stockholders coincided as to this aspect of a derivative action with the consequence that it is not an intra corporate matter as that term is here traditionally employed."

Now, the next paragraph of the Delaware Court's opinion answers quite well the problem that counsel for the defendants have suggested regarding the construction that this Court should put upon the Virginia Corporation Act.
[8] It has been pointed out there are many references to stockholders of record. I think Chancellor Harrington refers to most of them, although, of course, he was not speaking of the Virginia Statute.

> "For many purposes, such as voting, dividend payments, and appraisal proceedings, the corporation must have a rather inflexible basis of stockholder

identity. That rigidity is not needed where the equitable owner is seeking to protect the corporate interests. It places no undue burden on a corporation to permit an equitable owner to sue in such a situation because he must prove his ownership in order to maintain the action, and the need for the same certainty which prompted the courts to recognize only registered stockholders in other situations is therefore not apparent."

And then he goes on to say that his views are in accord with the views expressed by a number of other courts. In fact, he has already indicated that it is the majority rule.

Now, there is no question in this case before this Court that the plaintiffs were the equitable owners of stock. There is no controversy about the amount of stock. There is no question that stock was held in a street account. It has been [9] suggested because the stock was held in a street account, because the rules of the various brokerage houses allow the stock to be hypothecated, brokerage houses may go short, and for other reasons, that the equitable interest in it is destroyed. Well, that, of course, is conduct of the brokerage house inherent in the street name. If, because of these peculiar situations the Court were to hold that a person whose stock might be hypothecated could not maintain an action, it would simply be holding, in other words, that stock registered in a street name could not support such a suit.

It has also been suggested that because of the plaintiffs' margin trading, that there equitable ownership is defeated. Margin trading is a recognized form of trading. The Government approves it, controls it. The fact that stock is purchased on the margin, the Court believes, does not defeat the right to bring a suit such as this.

The Court believes that this is in accord with the majority view, although I must confess that counsel here have

developed the argument much further than most of the cases have developed it. Yet, in its essentials, the issue appears no different from the question whether a person need be a stockholder of record to bring suit.

[10] The Court probably should not concern itself with policy. But much investment money today is in street names. Much of the investment that goes on today is on the margin. This Court would be loathe to rule that in Virginia such a person does not have a right to bring a derivative suit. I doubt if the ruling of the Court would drive investment money from Virginia, but certainly it appears to me that Virginia should be in line with the other large commercial states in the country such as Delaware and New York. That is a question of policy which can be very readily determined by the General Assembly. At the present time they have not acted on it specifically one way or the other.

We come now to the most difficult question, and that is whether the stockholders who have brought this suit have complied with Rule 23(b) of the Federal Rules of Civil Procedure. That rule states in part:

> "The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort."

Now, it is significant that the rule requires the complaint [11] to be verified, and it is also significant that it says that "the complaint shall set forth with particularity the effort of the plaintiff—" That is a little bit different from the ordinary complaint because our rules ordinarily do not require us to set forth things with such particularity.

Turning to the Meltzer complaint, we find in paragraph 15:

> "Demand upon the board of directors of Atlantic to bring this action would be futile because:
>
> "(a) The board of directors is controlled and dominated by the alleged wrongdoers, through their official positions with Atlantic, and by virtue of their very substantial stockholdings;
>
> "(b) The directors have participated in the wrongs alleged;
>
> "(c) The directors have negligently permitted the aforementioned wrongs to occur and are liable therefor; and
>
> "(d) The institution of this action by the directors would place it in hostile hands and would prevent its effective prosecution."

In the Sterenstein complaint, we find paragraph 8:

> "No demand has been made upon the directors of Atlantic that Atlantic bring this action because [12] such demand would be futile. The members of the Board of Directors approved of and acquiesced in such wrongs, and personally benefitted thereby. They would not and could not have diligently prosecuted this action."

The Court has considered those allegations, all of the testimony of the plaintiffs and the letter to the stockholders which was brought to the attention of the Court by counsel for the plaintiff in his pretrial memorandum. Plaintiffs' counsel has asserted that the letter sets forth a great deal of the issues raised in the suits and that the plaintiffs rely upon the matters set forth in the letter to disclose the wrongdoings

The plaintiffs have relied primarily upon two of the leading cases. Certainly, one of them is the leading case—*Delaware & Hudson Company* v. *Albany & Susquehanna Railroad*, 213 U.S. 435.

Gentlemen, let me say, parenthetically, that I am not going to attempt to recite all of the cases which you have mentioned. In stating that you rely upon a case, I do not mean to in any way foreclose you. You have cited many cases in your brief, and they have been very helpful. But I tried to pick out those cases which I thought fairly typified the position that you took.

[13] That case sustains, to a great extent, the argument made by the plaintiff. Of course, at that time the rule did not say that you should set forth with particularity the reason for failing to make the demand. That was added, possibly, as a result of that case. The Court believes, however, that the case is not controlling.

Facts were certified to the Court in that case, and among those facts was:

> "So far as appears from anything shown in this record none of the directors or officers of the Delaware Company ever, before or after the bringing of this suit, treated the claim therein set forth otherwise than as one of doubtful validity the payment of which was to be resisted."

Of course, this is a case that involves an interlocking directorship, so that does appear among the factors. We do not have that factual situation, in the opinion of the Court, in the case at bar.

Another case mentioned by the plaintiffs, and which is a very helpful case, is *Cohen* v. *Industrial Finance Corporation*. I should say it is mentioned by both parties. It runs throughout your briefs. 44 F. Supp. 491, Southern District of New York, 1942. There, the Court said, on page 494:

[14] "A realistic view should be taken of the facts pleaded as excusing a demand on directors that they bring suit. The court should not cajole itself into believing that the members of a Board of Directors elected by the dominant and accused majority stockholder, after accusations of wrongdoing have been made, were selected for membership on the Board to protect the interests of the minority stockholders and to assure a vigorous prosecution of effective litigation against the offending majority. Where we know that puppet directors would at best only go through the motions, are we barred from considering who would be manipulating the wires? As stated in the Delaware & Hudson case, supra, the rule 'is intended to have practical operation, and to have that it must, as to its requirements, be given such play as to fit the conditions of different cases.'

"Whether or not a demand is excused in a particular case is a question for the court. In passing upon that question the Court should consider the whole complaint, not merely the paragraph in which the pleader summarizes his reasons for not demanding action by the directors or stockholders."

[15] Now I think, parenthetically, I should make it plain here so the record will be clear as to what I have done. This is a rather unique situation. Certainly, it is in this jurisdiction. Counsel have not cited any Fourth Circuit cases that are controlling. I have not only considered the complaint, but, as I have said before, I have considered the testimony of the plaintiffs and the letter to the stockholders which the plaintiffs have called to my attention and the statements in their briefs and the oral argument pertaining to the importance of that letter. So I have gone a little bit further than the Cohen case in considering the pleadings and evidence.

The Court in the Cohen case goes on to say:

> "I am of the opinion that the allegations of the complaint are adequate within the concept of Rule 23(b). Here the corporate directors of 'Acceptance' are alleged in effect to be mere 'dummies' for 'Finance.' Further the complaint shows that their interests and the interests of those who named them are antagonistic to the interest of 'Acceptance.' It is alleged that these directors 'have had knowledge of all the acts complained of herein and have acquiesced and participated therein.' It is also alleged that 'Finance,' one of the participants in the profits of the illegal transaction owns or controls 85% to [16] 90% of the common stock of 'Acceptance,' and has voting control of 'Acceptance.' The requirement of a demand should be dispensed with, where it is clear that a demand would be a useless gesture. Indeed, in cases such as this, where other representative actions by stockholders have been 'settled,' against the real interests of the injured corporation, it would be the height of folly to entrust the conduct of the litigation, either directly or indirectly, to the very people who are responsible for the wrongs, according to the complaint.
>
> "The present director of 'Acceptance,' with full knowledge of the facts, for years, have done nothing to protect the interests of that corporation, as the complaint alleges."

Again, the Court is of the opinion that the facts in that case do not coincide with the facts that we have before us. Of course, facts never coincide, but in their controlling features, in their most important phases they do not reach the situation, or are not comparable, to the situation that we have here.

Now, again, there are any number of cases, which have been cited for the other side in this situation. There are [17] Virginia cases. There are a number of Federal cases about the demand. I am not going to try to comment upon all of them. I would like to remark about *Levitan* v. *Stout*, 97 F. Supp. 105, W. D. Ky. (1951). I mention this because it has influenced my thinking about this case. I specifically asked counsel for the plaintiffs to advise me about it, which he did, and I appreciated it.

Now, that case has some factual situations similar to that which we have here. Mr. Lobell has drawn a distinction between that case and this case, which in many respects is valid. The case does, as he pointed out, concern primarily business ventures; and, as Mr. Boothe pointed out, one of them is the bourbon venture. There are other matters, however, concerning the employment contracts which the stockholders alleged were not proper.

There, the principal directors and stockholders controlled about 40% of the stock, which is very close to what we have today; and there, it was alleged:

> "* * * that demand on the Board of Directors would have been futile because three of the six directors who were in office at the commencement of the action are defendants herein and presumably would not authorize action against themselves, or permit such an action to be vigorously prosecuted [18] if it were instituted. It is alleged that demand on the stockholders of the corporation would have been futile because the stockholders, as such, have no authority to require the Corporation to commence legal action because ownership of the 60% of stock not held by defendants is scattered; and because a proxy fight, under the circumstances, would have imposed a great financial burden on the plaintiffs."

The Court says, at page 113:

"An additional reason for granting the motion to dismiss is that the plaintiffs have failed to exhaust their corporate remedies as required by Rule 23(b) of the Rules of Civil Procedure. As has been stated above, the plaintiffs have made no effort to induce the directors or stockholders of the Corporation to bring suit. Instead, they have endeavored to demonstrate that any efforts along this line would have been futile.

"In appraising the sufficiency of the allegations on this point, the Court must take account of the fact that, for all that appears in the record, it would have been a very simple matter for the plaintiffs to make demands upon the directors and shareholders. This could have been done, for example, by simply [19] mailing a copy of the complaint to the Board of Directors with a letter advising them that unless the Corporation enforced its rights within a reasonable time, the plaintiffs would undertake to do so on its behalf. If the Board of Directors had failed or refused to take action, the plaintiffs could have appeared at the next annual meeting of stockholders, presented a copy of the complaint, and urged the election of directors who would cause the Corporation to bring suit. • • •"

"It is well established that the courts will not take jurisdiction over intra-corporate disputes unless the ordinary corporate procedures are for some reason frustrated. "• • • A stockholder, in taking stock in the ordinary corporation, submits, within the charter limits, to a guidance of the corporate affairs according to the will of the owners of a majority of the stock and through the directors whom the majority choose. The minority have a right to have the majority exercise their judgment, and to exercise it honestly and not fraudulently, but have no right to have a court substitute their own ideas and wishes for those of the

majority, and that in advance of any refusal of the majority to hear [20] and decide on the matter at issue. Minority stockholders may not in the absence of sudden emergency ask a court of equity to interfere in the management of their corporation until they have earnestly and unsuccessfully sought redress from the Board of Directors, and where appropriate also from the stockholders in meeting, unless they can show sufficient reasons for not doing so.' "

Then the court goes on to say, at the bottom of page 114:

"Turning now to the allegations of the amended complaint in the present case, this Court must decide whether such allegations demonstrate the futility of a demand on the Board of Directors and stockholders. In the opinion of this Court, they do not. The central question is whether the ownership of 40% of the voting stock of a corporation is, as a matter of law, so clearly equivalent to full power over the Board of Directors that the directors will obey the orders of the owners of said stock—even in contravention of their own duty to act for the best interest of the corporation and despite their own responsibility for failure to do so. This Court cannot bring itself to such a conclusion."

[21] Now, in fairness to the plaintiffs, it should be stated here that there are allegations of more than the simple control. It goes further in this case, and that is one of the things that makes this particular suit rather difficult. Quoting again from *Levitan:*

"To be sure, there are conclusory allegations to the the effect that the defendants Stout and Dulaney dominated and controlled the Board of Directors, and that by reason of the scattered holdings of the other stockholders the defendants Stout and Dulaney had effec-

tive power to elect a majority of the Board of Directors."

Then the Court goes on to discuss the orderly and just procedure that Rule 23(b) sets forth and the reasons that the rule has been made.

We turn now to the peculiar situation in this case, that is the remedial action that has already been taken, the plaintiff's testimony and the interweaving aspects of those two things.

Without going into detail about dates, I think it is a fair statement to say that almost simultaneously with the preparation of the suits, the Board of Directors had under consideration the remedial action. How long they were under consideration by both parties, we do not know. We [22] do know that they appeared almost at the same time. The remedial actions is stated in full in the exhibit which plaintiffs have filed, under the title "Special Report to Stockholders of the Atlantic Research Corporation." Probably the most important steps that the Board took were:

To increase the Board of Directors by authorizing two new outside directors; authorizing an executive committee of three members of the Board, two to be outside directors and one of them an officer of the corporation. Dr. Arthur W. Sloan was made chairman and Rear Admiral Malcolm F. Schoeffel and James M. Johnston became the outside members. It named as general counsel the firm of Frost & Towers in Washington; arranged to retain the accounting firm of Price, Waterhouse & Co.; resolved to find a person well-versed in corporate finance; and took action respecting pledges to secure bank loans referred to in Note 13 to the Financial Statements.

These matters, I think, are also summarized and fairly stated in the Preliminary Statement filed by the defendants on page 14 and 15. It is not controverted that the power of the president was drastically curtailed. The Board

removed the President of the Company. It did assign him the position of Chairman of the Board, and it did obtain from Dr. Scurlock and Dr. Sloan a guarantee of certain [23] outstanding loans.

Now, where this case becomes unique is that this activity was going on at the time that the plaintiffs were preparing their suits. For that reason, the question of demand becomes particularly important in this case, the Court believes.

We turn to Mr. Meltzer's testimony. He has a great deal of testimony to which I am not going to advert. It does not mean that I do not believe it, but I am just going to pick out one part it appears to me is pertinent and unusual in this suit.

Speaking of this Special Report, Mr. Meltzer was asked a question on page 28 of the deposition:

> "When you read this report, didn't it outline remedial action which the Corporation said it had taken? A. Yes.
>
> "Q. Wasn't it the same remedial action that you are requesting in your lawsuit? A. I don't know. I am not sure. I didn't pay too much attention to it."

Now, it appears to the Court that if this plaintiff can say that he does not know whether the remedial action is all that he wanted, it ill behooves him to come into the [24] court and ask the Court to tell him.

Now, casting that within the framework of Rule 23(b), it appears that there is great possibilty that if he had followed Rule 23(b) in asking for the remedial action, that even if additional remedial action were not forthcoming, he might have been satisfied in what did take place.

It also is reasonable to speculate—and it is only speculation—that if he had called other matters to the attention of the Board while they were in a reform mood, so to

speak, they may have followed his suggestions. Certainly, we have not a situation here that the *Delaware & Hudson* case had. There it was certified: "So far as appears from anything shown in this record none of the directors or officers of the Delaware Company ever, before or after bringing this suit, treated the claim therein set forth otherwise than as one of doubtful validity • • •."

Here the Board has given this matter some concern.

Now, it is true, the Court recognizes, that the Board has not given all of the relief that the plaintiff seeks, but that is not the question before us on this motion. The question is whether Rule 23(b) has been complied with, or whether the allegations set forth are sufficient to excuse [25] the effort.

It also demonstrates that the situation is not the same as that in the Cohen case where the evidence was that the directors, with full knowledge of facts, for years had done nothing to protect the interest of the corporation, as the complaint alleges. In that case also, there have been other demands made by other stockholders.

Now we come to Mr. Sterenstein's testimony, and he is essentially in the same position as Mr. Meltzer, but he cannot say, for a very good reason, whether the remedial action taken would have been satisfactory to him. He was asked on page 46—the question was:

> "I am speaking of demand upon this Corporation or its stockholders or directors. A. I made no demands, no sir.
>
> "Q. Did you receive a special report from the Corporation with respect to the S.E.C. Investigation? A. To the best of my recollection, I did not receive it.
>
> "Q. Have you ever seen it? A. I do not think I did see it."

Now these complaints were probably prepared before the report. Counsel may be able to help me on that. I

[26] do not want to misstate any facts, but as far as I can determine, these things must have been going along fairly simultaneously. Certainly, the suit had been filed by the time that Mr. Meltzer saw the report.

Now, Mr. Sterenstein is essentially in the same position, and Mrs. Sterenstein.

He cannot say whether the action which he sought would have been better or not, or whether it has been met. Of course, I make this comment upon the testimony with full realization that they are still prosecuting the suit, but in making that comment I must also take into consideration that they have said time and again that they know very, very little about this, and they have left it up to their attorneys. It was the duty of the attorney to prosecute the suit diligently. But the Court cannot measure the plaintiff's rights by the action of the attorneys.

Counsel have urged me to rule on the question of whether the plaintiffs should have made a demand upon the stockholders. The Court believes that it is impossible to rule at this time because of the absence of a demand upon the directors. It is impossible to say whether or not a demand upon the stockholders should or should not have been made until the plaintiffs had gotten their answer from the directors. The Court believes that that is the fair [27] purport of that rule.

The Court believes that the rule which states, "and, if necessary, from the shareholders," means that they should apply to the shareholders if they had not gotten results from the directors. So the Court is not going to rule at this time. There is nothing to rule on.

The Court is of the opinion that Rule 23(b) has not been complied with.

Now, we have some other motions, and they pertain to service of process. As counsel have frankly stated, those motions are interwoven with whether the complaint states

a cause of action. We did not get into the motion on process in the way I would like to have it gone into in order to rule on it. Mr. Morgan stated he never heard of the exact basis of the complaint until Mr. Lobell spoke about it in what was essentially rebuttal argument. Then Mr. Morgan wanted me to take into conside tion a case which was not cited and which Mr. Lobell had no opportunity to read and comment upon. I just do not like to decide cases that way. Because of the peculiar situation in which we find ourselves, I think we will defer ruling on that. It is not necessary for the disposition of this case. If the case should come back to me, why, of course, we will have to rule on it. I must confess I did not realize how closely it was tied [28] with whether or not the complaint states a cause of action until I heard the oral argument today. I have not considered the case which Mr. Morgan says is controlling. I will not consider it unless Mr. Lobell has a chance to tell me it is not controlling.

I think what I have said disposes of the case. What I have tried to do is rule on the most important motions so if counsel wish to assign error and cross-error they may do so.

• • •

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
ALEXANDRIA DIVISION

Civil Action No. 2787

SAMUEL MELTZER, *Plaintiff*,

v.

ARCH C. SCURLOCK, et al. *Defendants*.

---

* * *

Order of the District Court

These causes having been consolidated for the purpose of hearing all motions by Order entered by the Court on February 1, 1963, came on upon the motions theretofore filed to be heard by the Court on Wednesday, May 29, 1963, the parties being present by counsel, the Plaintiffs all being represented by Nathan D. Lobell, Esquire, and George Giammittorio, Esquire, and all of the Defendants being represented by their respective counsel of record except Defendants Stuart L. Bailey, M. Lee Rice and Keith E. Rumbel, whose counsel, Robert Hirsch and Stanford E. Parris had filed responsive pleadings but who waived the privilege of attending the argument of the motions; whereupon the motions were argued by counsel for the Plaintiffs and for the Defendants, the said arguments being transcribed by the Court Reporter of this Court; and at the conclusion of all arguments the Court did recess the proceedings and upon convening, the Court after recess did hand down an opinion which was transcribed; and, for the reasons set forth in the said opinion,

It is ADJUDGED and ORDERED by the Court as follows:

1. The motions to dismiss on the ground that the subject matter of the actions is currently involved in a pro-

ceeding before the Securities and Exchange Commission, be and the same hereby are denied.

2. The motions to dismiss on the ground that Defendant, Atlantic Research Corporation is not a proper party Defendant, that the parties should be realigned and that Atlantic Research Corporation should be made a party Plaintiff, be and the same hereby are denied.

3. The motions to dismiss on the ground that the jurisdictional amount of $10,000.00 or more is not involved in these actions, be and the same hereby are denied.

4. The motions to dismiss on the ground of the lack of Plaintiffs' capacity to sue and on the ground that the Plaintiffs have no standing to maintain these actions because they are not stockholders of record, be and the same hereby are denied.

5. The motions to dismiss on the ground that Plaintiffs had failed to comply with Rule 23(b) of the Federal Rules of Civil Procedure as far as the Directors of Atlantic Research Corporation were involved, be and the same hereby are granted and these causes of action are hereby dismissed without prejudice.

6. The motions to dismiss on the ground that the Plaintiffs had failed to comply with Rule 23(b) of the Federal Rules of Civil Procedure insofar as the stockholders of Atlantic Research Corporation were involved, be and the same hereby are deferred.

7. The motions to dismiss on the ground of insufficiency of service of process, be and the same hereby are deferred.

8. Oral motion made by counsel for the Plaintiffs that the Court consider demand upon the Directors of Atlantic Research Corporation as made at that time and that the Court proceed to hear the causes on their merits, be and the same hereby is denied.

9. Counsel for the parties having excepted to all of the respective adverse rulings of the Court, such exceptions be and they hereby are allowed.

Entered this 19 day of July, 1963:

/s/ JOHN D. BUTZNER, JR.
John D. Butzner, Jr.
United States District Judge

* * *

Opinion—Filed and Entered April 9, 1964

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 9201

SAMUEL MELTZER, *Appellant*,

v.

ATLANTIC RESEARCH CORPORATION, et al., *Appellees*.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF VIRGINIA, AT ALEXANDRIA.
JOHN D. BUTZNER, JR., DISTRICT JUDGE.

(Argued January 23, 1964. Decided April 9, 1964.)

Before BRYAN and BELL, Circuit Judges and MICHIE, District Judge.

Sidney B. Silverman (Ewell C. Moore, Jr., Rutherford Day and Rosenfield & Silverman on brief) for Appellant, and Armistead L. Boothe (James W. Crowley, Ira P. Barsky, Louis Koutoulakos, John A. Beck, Charles S. Rhyne, Thomas P. Brown, III, Ganson Purcell, E. Ladd Thurston and Courts Oulahan on brief) for Appellees.

ALBERT V. BRYAN, Circuit Judge:

This derivative suit by shareholder Samuel Meltzer against the Atlantic Research Corporation and its then five directors was dismissed by the District Court on the ground that the plaintiff had failed first to demand of the directors "such action as he desires" of the corporation—that is to sue for recovery of losses it suffered from the alleged misfeasance or nonfeasance of the directors. This exaction of the plaintiff was predicated on Rule 23(b), Fed.R.Civ.P. reading pertinently as follows:

> "The complaint [in a secondary action] shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort."

Appealing, the shareowner contends that a demand would have been in vain and, indeed, ineffectual if granted. We agree.

The complaint was filed on behalf of all the other shareholders. As the decision was passed on a motion to dismiss or for summary judgment, the allegations of the plaintiff are to be treated as admitted or as not genuinely in issue. So taken, they depict such misfeasance by two directors—Arch C. Scurlock and Arthur W. Sloan—and such nonfeasance by the other three as to demonstrate the emptiness of resort to them.

Scurlock and Sloan, according to the complaint, own 418,790 and 372,530 shares of Atlantic's common stock, that is 21% and 18%, respectively. It further averred that together with the other three defendant directors, Scurlock as director and president, and Sloan as vice-president and director, dominated Atlantic.

Plaintiff, a beneficial holder of stock since 1960, commenced the present action on November 13, 1962 and on

January 3, 1963 filed an amendment, here treated as the complaint. He charges that on October 10, 1962 the Securities and Exchange Commission suspended the trading of Atlantic's stock on the American Stock Exchange because of the publication by Atlantic of false financial statements, including the failure to disclose certain unauthorized diversions of corporate moneys.

The misapplications were alleged as committed in 1962 and prior years. The first was the loan of $3,900,000 by Atlantic at the instance of Scurlock to "certain intermediaries". The censure is: that he had borrowed upon nearly all of his stock in Atlantic; that the market price of this stock began to decline sharply in June 1961; that as the price fell the value of the investment of the individual defendants decreased; and that in order to prevent further dwindling of their investments and to prevent shrinkage of Scurlock's security for his loans, with possible foreclosure by sale of his Atlantic shares, Scurlock and the other defendant directors determined to support the market price of Atlantic's shares. This was accomplished, the complaint declares, through the loans of $3,900,000, as the intermediaries were to use the proceeds to buy Atlantic shares on the market. This process was completed with the pledge of the newly purchased shares to Atlantic as security for the notes representing the $3,900,000.

In addition to citing Scurlock as using Atlantic's funds to defray his living, entertainment and personal traveling expenses, the complaint goes on to tax him and the other defendant directors with financing other companies in which Scurlock and Sloan were largely interested; and that these funds were used to acquire and improve land of these companies which in turn leased them to Atlantic on unfavorable terms. The complaint submits that all of these transactions were effected or brought about by Scurlock and Sloan and were participated in, or negligently tolerated by, the other defendant directors.

Injury to Atlantic is summarized in this way: that the false publication with resulting suspension by the S.E.C. of market trading in its shares gravely impaired the credit of Atlantic; that the security for the loans of $3,900,000 is substantially less in value than their face amounts; that the loans were illegal, as they were made by Atlantic to acquire its own stock; that this employment of these moneys—said to be 20% of its total assets—withdrew that sum from the intended aims of the corporation; and that these loans, as well as the appropriation of Atlantic's funds to the use of the other companies in which Scurlock and Sloan were interested, constituted "a waste and spoliation of Atlantic assets".

None of the acts or apathy of the defendants as pleaded was denied. The defense is that the directors have taken all the rehabilitative measures which could be required of them by the corporation, and this action proves the wisdom of the prerequisite of a demand before suit. The only denial is the averment of the insecurity of the loans of $3,900,000.

In this background, demand of the directors that the corporation recapture these loans and appropriations, as well as recover damages suffered by the corporation, would have been utterly unavailing. The plaintiff points out that Scurlock and Sloan with the other defendant directors dominate the Board, for they were the Board. It was too much to expect that the Board would direct the corporation to sue themselves. Furthermore, such a suit, as the plaintiff asks, would be controlled by the Board and for this reason it is artless indeed, and faithless to the corporation, to leave the prosecution of it to the defendants therein. Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85, 88 (2 Cir. 1955), 251 F.2d 340 (1957). This is demonstrated by the fact that they have already caused the corporation itself to join in the strenuous defensive moves in this suit. *Cf.* Liggett v. Roanoke Water Co., 126 Va. 22, 101 S.E. 55, 57 (1919).

The necessity and sufficiency of the preliminary demand upon the directors, and the circumstance which satisfies omission of such demand, under Rule 23(b) would seem to be procedural in nature and hence governed by Federal law. See Delaware & Hudson Co. v. Albany & Susquehanna R.R., 213 U.S. 435, 451 (1909); Quirke v. St. Louis-San Francisco R.R., 277 F.2d 705 (8 Cir.), *cert. denied*, 363 U.S. 845 (1960); but see Steinberg v. Hardy, 90 F.Supp. 167 (D.Conn. 1950). In any event, Virginia decisional law appears to be in accord. In Liggett v. Roanoke Water Co., *supra*, 126 Va. 22, 101 S.E. 55, the Court declared:

> "[U]nder the well-established and admitted doctrine . . . a stockholder may maintain such a suit for a wrongful diversion of the assets of a corporation if he alleges and proves that a request or demand has been made upon the board of directors, or other body managing the corporation, to institute proceedings against the wrongdoer, and that they have refused to do so after a reasonable request or demand, or upon the allegation and proof of such facts as shown that it is reasonably certain that a demand for corporate action would have been useless".

On the allegations of the complaint, the plaintiff is certainly also to be forgiven the omission of a request upon the stockholders to force restoration of Atlantic's losses. While the District Court did not reach that point, we see at once the futility of any such importunity upon the shareholders. With Scurlock and Sloan holding 40% of the voting stock, even without consideration of the stock holdings of their associates, it would be costly business in time and money for the smaller holders to compel the corporation to protect its rights. The stock is widely distributed and the convening of a sufficient number of the remaining 60% for a discussion and vote would certainly not be readily feasible. *Cf.* Delaware & Hudson Co. v. Albany & Susquehanna R.R., *supra*, 213 U.S. 435, 451.

In defense, as already noted, the directors maintain that demand upon them would have achieved all of the aims of the present plaintiff. For proof they refer to the redemptive action of the Board upon learning of S.E.C.'s accusation. But this was severely wanting in satisfaction. The first step of the Board was to authorize two additional directorships, 7 instead of 5. The two directors to be added were persons not already within the corporation. However, their selection was left to the very persons now sued. The immediate result was only remotely remedial. Next, the Board authorized the creation of an executive committee consisting of three members and removed Scurlock as president. But he was immediately elected Chairman of the Board. At once Sloan was made president and the "chief executive authority over the corporation" was placed in him. Thus the very persons of whom complaint was made were retained in top rank positions.

Apart from employing a law firm to act as general counsel for the corporation, procuring a reputable accounting firm, and circulating financial statements, the only other reconstructive action of the Board was to obtain guarantees from Scurlock and Sloan of the outstanding loans of $3,900,000. These notes were impliedly admitted to be of doubtful value by the new accountant's requirement that a reserve be set up against their loss. The damage done by the loans of $3,900,000 is not cured by the guarantee of Scurlock and Sloan. Such misdirection of company funds is cured by not less than the immediate return of the money to the corporation. The action of the Board ratifies the loans rather than repudiates them. In oral argument we are told that the guarantee of Scurlock is of little value because of encumbrances upon his assets.

Again, if the defendant directors other than Scurlock and Sloan did approve these loans or were derelict in discovering or recognizing and opposing them, the corporation undoubtedly has a claim against them for any resulting loss. O'Connor v. First Nat. Investors' Corporation, 163

Va. 908, 177 S.E. 852 (1935). All of this applies with equal force to any channeling of corporate money into other companies.

Virginia decisional law acknowledges and upholds a cause of action on the facts alleged by the appellant. Liggett v. Roanoke Water Co., *supra*, 126 Va. 22, 101 S.E. 55. This right of a minority stockholder has long been elementary in the Federal courts too. Delaware & Hudson Co. v. Albany & Susquehanna R.R., *supra*, 213 U.S. 435, 451. We do not intend to hold that the charges in the complaint are true. The only question before us is whether the facts well pleaded there excused the plaintiff from a prefatory demand upon the directors and stockholders. To repeat, we think they do.

The judgment of dismissal must be reversed, and the action remanded for trial.

Reversed and Remanded.

Judgment

Filed and Entered, April 9, 1964.

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 9201

SAMUEL MELTZER, *Appellant*,

v.

ATLANTIC RESEARCH CORPORATION, ET AL., *Appellees*.

Appeal from the United States District Court for the Eastern District of Virginia.

This cause came on to be heard on the record from the United States District Court for the Eastern District of Virginia, and was argued by counsel.

On considetation whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court appealed from, in this cause, be, and the same is hereby, reversed with costs; and that this cause be, and the same is hereby, remanded to the United States District Court for the Eastern District of Virginia, at Alexandria, with direction to grant a trial in accordance with the opinion of the Court filed herein.

ALBERT V. BRYAN,
United States Circuit Judge.

J. SPENCER BELL
United States Circuit Judge.

THOMAS J. MICHIE
United States District Judge.

Office-Supreme Court, U.S.
FILED
JUL 24 1964
JOHN F. DAVIS, CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1964

No. 326

ARTHUR W. SLOAN, FRANKLIN C. SALISBURY, AND ATLANTIC RESEARCH CORPORATION, *Petitioners,*

v.

SAMUEL MELTZER, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT.

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INDEX

	Page
Opinions Below	1
Jurisdiction	2
Question Presented	2
Federal Rule of Civil Procedures Involved	2
Statement	3
Proceedings Before the District Court	4
The Proceedings in the Fourth Circuit	7
Reasons for Granting the Writ	8
I. The Issue Involved in This Case Is One of National Importance	8
II. The Purpose and Intent of Rule 23(b) Is To Prevent Unnecessary Litigation	11
III. Failure to Follow Decisions of This Court, a Conflict in the Circuit Courts, and Inconsistent Holdings in the District Courts Require Clarification of Rule 23(b) by This Court	15
Conclusion	20
Appendix A	
Text of Opinion of Circuit Court	21
Appendix B	
Text of Opinion of District Court	27
Appendix C	
Order Denying Rehearing	48
Appendix D	
Excerpts From Deposition of Samuel Meltzer	49
Appendix E	
Affidavit of the Secretary of Atlantic Research Corporation	53
Appendix F	
Excerpts of Special Report to Stockholders of Atlantic Research Corporation	59

Table of Authorities

Cases:

	Page
Bruce & Co. v. Bothwell, 8 F.R.D. 45 (D.C. N.Y. 1948)	11
Cohen v. Industrial Finance Corp., 44 F. Supp. 491 (S.D. N.Y. 1942)	14, 17
Cold Metal Process Co. v. United Engineering and Foundry Co., 351 U.S. 445	9
Delaware and Hudson Co. v. Albany and Susquehanna R. Co., 213 U.S. 435	11, 12, 19
Dempfel v. Ohio & M. R. Co., 110 U.S. 209	13
Goldstein v. Groesbeck, 142 F. 2d 422 (2nd Cir. 1944)	12
Gottesman v. General Motors Corp., 268 F. 2d 194 (2 Cir. 1959)	18
Greenwood v. Union Freight Co., 105 U.S. 13	14
Group of Boston & P.P.C. Stockholders v. Interstate Commerce Commission, 133 F. Supp. 488 (E.D. Va. 1955)	15
Guth v. Groves, 44 F. Supp. 851 (S.D. N.Y. 1942)	17
Haffer v. Voit, 219 F. 2d 704 (6th Cir. 1955)	15, 18
Hawes v. City of Oakland, 104 U.S. 450	12, 13, 14, 16, 19
Huntington v. Palmer, 104 U.S. 482	13
Isaac v. Milton Mfg. Co., 33 F. Supp. 732 (M.D. Pa. 1940)	16
Jacobson v. General Motors Corp., 22 F. Supp. 255, 257 (S.D. N.Y. 1938), 97 F. Supp. 105 (W.D. Ky. 1951)	11
Leriton v. Stout, 97 F. Supp. 105, 113-116 (W.D. Ky. 1951)	15, 18
Long v. Stiles, 88 F. 2d 554 (6th Cir. 1937)	16
Lucking v. Delano, 129 F. 2d 283 (6th Cir. 1941)	14, 15, 16, 17
Mississippi Publishing Corp. v. Murphree, 326 U.S. 438	9, 9
City of Quincy v. Steel, 120 U.S. 241	14, 16, 19
Quirke v. St. Louis-San Francisco Ry. Co., 277 F. 2d 705 (8th Cir. 1960)	18
Rio Grande Irrigation & Colonization Co. v. Gildersleeve, 124 U.S. 603	10

Page

Rogers v. *American Can Co.*, 187 F. Supp. 532 (S.D. N.J. 1960) 14
Saxton v. *W. S. Askew Co.*, 38 F. Supp. 323 (N.D. Ga. 1941) 10
Sears, Roebuck & Co. v. *Mackey*, 351 U.S. 427 9
Shimer v. *Milton Mfg. Co.*, 10 F. Supp. 943 (M.D. Pa. 1935) 17
Sibbach v. *Wilson & Co.*, 312 U.S. 1 9, 9
Squair v. *Lookout Mountain Company*, 42 F. 729 (E.D. Tenn. 1890) 19
Watson v. *United States Sugar Refinery*, 68 F. 769 (9th Cir. 1895) 19, 19
Ziegler v. *Lake Street Elevated Ry. Co.*, 76 F. 662 (7th Cir. 1896) 17, 19, 19

Statutes and Regulations:

62 Stat. 928, 28 U.S.C. 1254 2
48 Stat. 1064, 28 U.S.C. § 2072 2, 9
Federal Rules of Civil Procedure—Rule 23(b) 2, 2, 3, 7, 7, 8, 8, 10, 10, 11, 11, 12, 13, 13, 15, 15, 15, 16, 16, 19, 19, 19
Rule 39(b) 10
Rule 52(a) 10

Orders of the Supreme Court of the United States:

314 U.S. 720 9
368 U.S. 1011 9
368 U.S. 1019 9
368 U.S. 1044 9
374 U.S. 871 9

Miscellaneous:

Barron & Holtzoff, *1 Federal Practice and Procedure* § 9 at 43-80 and 1963 Pocket Part at 19-25 10

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1964

No.

ARTHUR W. SLOAN, FRANKLIN C. SALISBURY, AND ATLANTIC RESEARCH CORPORATION, *Petitioners,*

v.

SAMUEL MELTZER, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT.

Petitioners, Arthur W. Sloan, Franklin C. Salisbury, and Atlantic Research Corporation, pray that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Fourth Circuit, entered in the above entitled cause on April 9, 1964, rehearing denied May 21, 1964.

Opinions Below

The opinion of the Court of Appeals for the Fourth Circuit is reported in 330 F. 2d 946, and printed as Appendix A of this petition. The opinion of the United States District Court for the Eastern District of Virginia, Alexandria Division, dated May 29, 1963, is printed as Appendix B of this petition.

Jurisdiction

The decision of the Court of Appeals setting aside the judgment of the United States District Court for the Eastern District of Virginia, Alexandria Division, was entered on April 9, 1964. A timely petition for rehearing was filed on May 7, 1964, and was denied on May 21, 1964. The order denying rehearing is printed as Appendix C of this petition. The jurisdiction of this Court is invoked under 28 U.S.C. §1254.

Question Presented

Where the plaintiff-shareholder admits on deposition that a demand upon a board of directors was not even considered prior to the filing of the complaint in a purported derivative shareholders' suit, can the plaintiff-shareholder nullify Rule 23 (b) of the Federal Rules of Civil Procedure, which requires this administrative remedy be exhausted, by naming each individual director a defendant in such action and making general charges of complicity in wrongdoing against the directors as a group?

Federal Rule of Civil Procedure Involved

The Rule in question is Rule 23 (b) of the Federal Rules of Civil Procedure (28 U.S.C. following §2072). The Rule states as follows:

> "(b) Secondary action by Shareholders. In an action brought to enforce a secondary right on the part of one or more shareholders in an association, incorporated or unincorporated, because the association refuses to enforce rights which may properly be asserted by it, the complaint shall be verified by oath and shall aver (1) that the plaintiff was a shareholder at the time of the transaction of which he complains or that

his share thereafter devolved on him by operation of law and (2) that the action is not a collusive one to confer on a court of the United States jurisdiction of any action of which it would not otherwise have jurisdiction. The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort."

Statement

Respondent (plaintiff and appellant below), the owner of 100 (out of 1,900,000 issued) shares of Atlantic Research Corporation (Atlantic) filed an original complaint on November 13, 1962, against the Corporation and each individual member of the Board of Directors. On January 3, 1962, Respondent filed an amended complaint, which alleged chiefly that defendant Scurlock, then President of Atlantic, diverted some $3,900,000 of Atlantic's money by loaning the $3,900,000 to various companies controlled by himself or defendant Sloan. Those companies then allegedly used the money to buy Atlantic's stock on the open market. It was alleged that, as security for these loans, Atlantic stock was pledged and that, because of a decline in market price of Atlantic's stock, Atlantic may lose several million dollars.

The original complaint in paragraph 15 and the amended complaint in paragraph 20 attempt to excuse the failure to make the demand upon Atlantic's Board of Directors, or shareholders, which is required by Rule 23 (b) of the Federal Rules of Civil Procedure, by the following allegations:

"(a) The Board of Directors is controlled and dominated by the alleged wrongdoers, through their offi-

cial positions with Atlantic, and by virtue of their very substantial holdings;

(b) The Directors have participated in the wrongs alleged;

(c) The Directors have negligently permitted the aforementioned wrongs to occur and are liable therefore; and

(d) The institution of this action by the directors would place it in hostile hands and would prevent its effective prosecution."

The testimony in the record herein demonstrates these allegations are false. The District Court expressly found that the facts established by testimony under oath conclusively disproved the complaint's allegations (Appendix B, p. 40). The Court of Appeals overruled this factual finding and reversed on the basis of the disproved allegations of the amended complaint (Appendix B, p. 23).

The amended complaint is based chiefly on orders of the Securities and Exchange Commission (SEC) beginning with an order suspending trading in the stock of Atlantic issued on October 10, 1962. Subsequently, on November 7, 1962, the SEC issued an order authorizing the institution of proceedings with respect to a registration statement of Atlantic filed in July, 1962. On November 9, 1962, the SEC's "Statement of Matters" issued in connection with such proceedings was made public. On November 9, 1962, the Board of Directors of Atlantic mailed all shareholders of Atlantic the SEC "Statement of Matters" as well as a Special Report. This Report set forth the details of many of the transactions which gave rise to the

SEC's action and recited various corrective measures which were being undertaken by Atlantic's management (Appendix F, p. 59). Such measures, as found by the District Court, included among others: (1) Increasing the Board of Directors by electing two new outside directors, (2) Authorizing an Executive Committee of three members of the Board, two to be outside directors; (3) Realignment of the executive officers of Atlantic so as to remove defendant Scurlock as President and naming both a new Chief Executive Officer and a new President; (4) Retaining, for the first time, an outside law firm as general counsel; (5) Retaining a new accounting firm; (6) Finding and engaging a person well versed in corporate finance as Treasurer; (7) Action to pledge additional security for certain bank loans; (8) A guarantee by defendants Scurlock and Sloan against loss by Atlantic on the questioned loans owed to Atlantic from various companies plus a pledge of the stock purchased with the loaned money and a second mortgage. See affidavit of Atlantic's Secretary (Appendix E, p. 53).

The District Court found that these major remedial steps clearly indicated that, at the time it would have been appropriate for the plaintiff below to make a demand on the Board, an independent and disinterested majority of the Board were in charge of the Corporation's affairs. Under these circumstances, a demand on the part of the plaintiff below would not have been futile. The District Court so found. (Appendix B, p. 39-40).

Respondent testified that he signed the original complaint on November 10, 1962, before he received the Special Report, dated November 9, 1962. Respondent, by his own admission, did not consider or even discuss with his counsel the matter of making demand on Atlantic or its Board of Directors that it take remedial actions to remedy his alleged complaint as to which he testified he knew of

no damage actually suffered by Atlantic (Appendix D, p. 51). He testified:

Q. "When you contacted your counsel, did he suggest to you that you contact Atlantic Research for an explanation of this matter before you filed a lawsuit?

A. "No. It was not necessary. The whole story was known to everybody by the press.

Q. "He did not suggest to you that you make a demand upon the officers or directors or the stockholders of Atlantic Research?

A. "No, he did not.

Q. "Did he say anything to you about making such a demand and waiting 60 days before filing your lawsuit?

A. "Not that I recall, no.

Q. "This demand was not discussed at all, then?

A. "No, sir.

* * * * * * *

Q. "Was it your decision not to contact the Corporation or its officers and directors and other stockholders before filing this lawsuit, or just whose decision was it?

A. "It was my decision.

Q. "And you say you did not even discuss it with your attorneys?

A. "No." (Appendix D, p. 51).

Moreover, although before filing his amended complaint on January 3, 1963, Respondent received the Special Re-

port which outlined the remedial actions taken by Atlantic referred to above, he testified he did not pay much attention to it. (Appendix D, p. 51-52).

Proceedings Before The District Court

The defendants below, after taking plaintiff's deposition, moved to dismiss the complaint on the ground that the plaintiff below had failed to make a demand for the remedial action he seeks upon Atlantic's Board of Directors as required by Rule 23 (b) of the Federal Rules of Civil Procedure. The District Court held a hearing at which it considered the extensive testimony of plaintiff on this issue. The District Court in its findings of fact and opinion took special note of plaintiff's testimony that he did not even consider making a demand upon the Board of Directors prior to the filing of the complaint. (Appendix D, p. 51). The District Court, in dismissing the complaint without prejudice to refiling after compliance with Rule 23(b), properly reasoned that, "if this plaintiff can say that he does not know whether the remedial action is all that he wanted, it ill behooves him to come into the court and ask the court to tell him." (Appendix D, p. 40). See also testimony in Appendix D, p. 51.

Proceedings in the Fourth Circuit.

The Respondent appealed the ruling of the District Court to the United States Court of Appeals for the Fourth Circuit. The Court of Appeals held that a demand on the Board of Directors would have been in vain and ineffectual. (Appendix A, p. 21). The Court of Appeals reasoned that, despite the contrary testimony of plaintiff before the District Court, *supra* page 6 the general allegations of the complaint quoted above should be treated

as admitted. The Court of Appeals, therefore, reversed the factual findings of the District Court and reversed the District Court's decision based thereon.

REASONS FOR GRANTING THE WRIT

I. The Issue Involved in This Case Is One of National Importance

The issue involved in this case is one of national importance because it affects a large volume of litigation in both Federal and state courts. It calls for the exercise by this Court of its supervisory powers to insure that the purpose of the Federal Rules of Civil Procedure is adhered to by the federal court system. The effectiveness of Rule 23(b) will be nullified if the decision of the Court of Appeals is not reversed. That Court's decision is in direct conflict with the clear, express purpose of the Federal Rules of Civil Procedure. This purpose is to secure the just, speedy and inexpensive determination of every shareholder claim initially by those most familiar with the facts, the corporation's Board of Directors. Failure of the Board to act allows the filing of a Court action to secure the relief desired by a shareholder. The shareholder is required to set forth in any court complaint he files, with great particularity, his efforts to secure relief from the Board or the other shareholders. Thus does Rule 23(b) re-emphasize that resort to the Board or other shareholders as a group for remedial action is required before the complaining shareholder has standing to maintain a derivative shareholders' suit in Court. And thus is recognized the fact that such a suit initially belongs to the corporation itself, and that the benefits of such a suit (other than counsel fees) belong to the corporation.

The fact that this Court promulgated the Federal Rules of Civil Procedure as formulated and recommended by the

Advisory Committee does not foreclose consideration by this Court of their validity, meaning or consistency. *Mississippi Publishing Corp.* v. *Murphree*, 326 U.S. 438, 444. The policy envisaged by the enabling act of June 19, 1934,[1] was that the whole field of court procedure be regulated in the interest of speedy, fair and exact determination of the truth. The Rules comport with this policy. *Sibbach* v. *Wilson & Co.*, 312 U.S. 1, 14. This Court has continued its interest in, and supervision of, the Rules by its order making the Advisory Committee a continuing body. 314 U.S. 720. In a whole series of important decisions this Court consistently has upheld the purpose and validity of the Rules and has reversed decisions which conflict with that purpose. See, for example, *Sibbach* v. *Wilson & Co.*, 312 U.S. 1, 13-15; *Mississippi Publishing Corp.* v. *Murphree*, 326 U.S. 438, 445-446; *Sears, Roebuck & Co.* v. *Mackey*, 351 U.S. 427, 436-438; *Cold Metal Process Co.* v. *United Engineering & Foundry Co.*, 351 U.S. 445, 452-453.

This Court's active interest in and supervision of the Federal Rules of Civil Procedure is demonstrated by four orders adopting amendments thereto which have originated by recommendation of the appropriate committees. In 368 U.S. 1019, 1023-1041, this Court extended certain deposition and discovery provisions of the Rules to the rules of practice in admiralty and maritime cases. In 368 U.S. 1014, 1015-1018, Rules 25, 54, 62, and 86 were amended. In 368 U.S. 1044, 1047-1070, considerable clarifying revision of many of the bankruptcy general orders and forms was made. In 374 U.S. 871, 875-900, further clarifying amendments were made to the Rules.

Viewed in perspective, the Federal Rules of Civil Procedure have lived up to their purpose of reducing unneces-

[1] 48 Stat. 1064, 28 U.S.C. § 2072.

sary litigation and improving the administration of justice in the Federal courts by eliminating technicalities and speeding up the disposition of cases. These Rules have been substantially adopted in twenty or more states. Similar rules have been adopted in most of the other states.[2] Consequently, the decision of the Court below will have a broad effect not only in the Federal court system but also in the state courts because of their rules comparable to Rule 23(b).

The Court of Appeals has defeated the salutary purpose of Rule 23(b). It has opened the door to direct court aid to all shareholders who make unsupportable charges against a majority of any board of directors. This decision is contrary to the unambiguous language of the Rule. The decision will encourage a flood of litigation in the Federal and state courts contrary to the purpose of the Rule. Where, as here, there is sworn testimony which is relied upon by the District Court in its findings there is no reason whatever to give broad general conclusory statements in the complaint the status of incontrovertible facts. But the Court of Appeals did exactly that.

A duly authorized rule of Court has the force of law, is binding upon the Court as well as upon parties to an action, and cannot be dispensed with to suit the circumstances of any particular case. *Rio Grande Irrigation & Colonization Co.* v. *Gildersleeve*, 174 U.S. 603, 608-609. The Federal district courts have a wide discretion in interpreting and enforcing civil procedure rules in order that speedy and efficient administration of justice may be secured. *Saxton* v. *W. S. Askew Co.*, 38 F. Supp. 323, 325 (N.D. Ga. 1941). The effect of the decision of the Court

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[2] See Barron & Holtzoff, 1 *Federal Practice and Procedure*, § 9 at 43-80 and 1963 Pocket Part at 19-25.

of Appeals herein takes this discretion away from the District Court and goes even further. It also constitutes the Court of Appeals the trier of facts in violation of Rules 39(b) and 52(a) of the Federal Rules of Civil Procedure.

II. The Purpose and Intent of Rule 23(b) Is To Prevent Unnecessary Litigation

The purpose of the prior demand requirement in Rule 23(b) is to prevent a flood of unnecessary litigation in the courts. The authority to sue for corporate injuries is primarily in the corporate management. When the shareholder sues, not upon an individual right, but a right which properly belongs to the corporation, and to which the fruits of the judgment go, his status—or standing—as a plaintiff is conditional upon his prior request that the primary holder of the right sue. In accordance with public policy, Rule 23(b) requires that the complaining plaintiff should not be able to attempt to control corporate management without first requesting appropriate action by the directors and, if need be, by the stockholders. *Bruce & Co.* v. *Bothwell*, 8 F.R.D. 45, 46-47 (S.D. N.Y. 1948); *Jacobson* v. *General Motors Corp.* 22 F. Supp. 255, 257 (S.D. N.Y. 1938). In the *Jacobson* case, the Court emphasized that "[p]rior demand or its equivalent . . . is a universally accepted principle of equity and has been applied in most federal cases, regardless of their origin or nature." If the board of directors acts within its powers and not wrongfully, a derivative suit cannot be maintained. *Delaware & Hudson Co.* v. *Albany and Susquehanna R. Co.*, 213 U.S. 435, 444, 446-447, 451. This is especially true here where the directors took remedial action which was not even considered by the respondent before he filed his complaint and his amended complaint. Appendix D, p. 51.

In the *Delaware and Hudson* case, it was certified that:

> "So far as appears from anything shown in this record, none of the directors or officers of the Delaware Company ever, before or after bringing this suit, treated the claim therein set forth otherwise than as one of doubtful validity. . . ."

This Court therefore held that, in a situation where "emergencies may arise in which the antagonism between the directors and the corporate interest may be unmistakable . . . the requirements of the [former Equity] rule [94] may be dispensed with." The Court of Appeals decision is clearly in conflict with this Court's rationale in *Delaware & Hudson Co.* Here the directors of Atlantic Research Corporation did take remedial action of great consequence. True, respondent ignored that action, but this does not wipe out the fact that remedial action was taken, and that Respondent received a written report reciting that action prior to the filing of his amended complaint.

The leading case concerning the prior demand requirement by shareholders on boards of directors is *Hawes* v. *City of Oakland*, 104 U.S. 450, 460-462. Rule 23(b) is merely an enactment with minor variance of the original Equity Rule 94 established in the *Hawes* case which later became Equity Rule 27. See *Goldstein* v. *Groesbeck*, 142 F. 2d 422, 425 (2d Cir. 1944).

In the *Hawes* case, this Court declared at page 461:

> "But, in addition to the existence of grievances which call for this kind of relief, it is equally important that before the shareholder is permitted in his own name, to institute and conduct a litigation which usually belongs to the corporation, he should show, to the satis-

> faction of the court, that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be made apparent to the court. If time permits, or has permitted, he must show, if he fails with the directors, that he has made an honest effort to obtain action by the stockholders as a body, in the matter of which he complains. And he must show a case, if this is not done, where it could not be done, or it was not reasonable to require it."

The *Hawes* case was followed by *Huntington* v. *Palmer*, 104 U.S. 482, 483-484, and *Dempfel* v. *Ohio and Mississippi R. Co.*, 110 U.S. 209, 210-211.

In the case at bar, no demand was made, or even contemplated, by Respondent as required by the consistent decisions of this Court and Rule 23(b). Respondent had nothing to lose and everything to gain by making a prior demand on Atlantic's Board of Directors. If such a demand had been made and Atlantic's Board had been advised of remedial action deemed necessary by Respondent, it is quite possible that there would be no need for these Petitioners to seek relief in the District Court or in this Court now. For, if Respondent had made a demand on Atlantic's Board seeking specific remedial steps and that demand had been refused, then, clearly, Respondent would have been justified in bringing a derivative action. But, as has been shown, Respondent did not seek the proper remedy or exhaust the remedies provided for him. As a result, his action, and the decision of the Court of Appeals herein, is contrary to thi Court's decisions in *Hawes*

and the other cases cited above and the intent and purpose of Rule 23(b).

It is uniformly held that courts will not entertain a derivative suit by stockholders on behalf of a corporation unless it clearly appears that all remedies within the corporation itself have been resorted to in vain. *Hawes* v. *City of Oakland*, 104 U.S. 450, 460-461; *Greenwood* v. *Union Freight R. Co.*, 105 U.S. 13, 15-16; *Cohen* v. *Industrial Finance Corporation*, 44 F.Supp. 491, 494-495 (S.D. N.Y. 1942); *Rogers* v. *American Can Co.*, 187 F.Supp. 532, 537 (D. N.J. 1960). And the Courts constantly stress that required demand upon corporate directors and shareholders is not a mere formality but must be an earnest effort to obtain action. *Lucking* v. *Delano*, 129 F.2d 283, 285-286 (6th Cir. 1942).

The foregoing prerequisite of prior demand upon a board of directors, before a shareholders' derivative action, cannot be dispensed with in such cursory fashion as Respondent admits he has done in this case. *City of Quincy* v. *Steel*, 120 U.S. 241, 247. There this Court said:

> "The rule [former Equity Rule 94] also requires that he must set forth with particularity his efforts to secure action on the part of the managing directors or trustees of the corporation of which he is a member, and, if necessary, of the shareholders, and the causes of his failure to obtain such action. . . ."

The reasons for the demand requirement upon corporate directors or shareholders, as a condition precedent to the maintenance of a derivative action, are important. If every shareholder were allowed to bring suit at his individual pleasure, the directors would find themselves harassed by a multiplicity of suits, and the courts would be swamped with endless litigation. In addition to guard-

ing against vexatious suits, the demand requirement facilitates authoritative management decisions without harassment and minimizes judicial interference in internal corporate affairs. Moreover, in many cases, such as the instant case, failure to make demand would be unjust and inequitable in subjecting Atlantic and other defendants to litigation and the substantial expenses incurred therewith. Also, the courts have emphasized in their decisions that the possibility of narrowing the issues or shortening the trial are additional reasons supporting the requirement of a prior demand upon the corporate directors and shareholders before a single shareholder institutes an action. *Lucking* v. *Delano*, 117 F.2d 159, 160 (6th Cir. 1941); *Haffer* v. *Voit*, 219 F.2d 704, 705 (6th Cir. 1955); *Group of Boston & P.R.C. Stockholders* v. *Interstate Commerce Commission*, 133 F.Supp. 488, 492-493 (E.D. Va. 1955); *Levitan* v. *Stout*, 97 F.Supp. 105, 113-116 (W.D. Ky. 1951).

In the case at bar, the record clearly shows that Atlantic's Board of Directors gave attention to the very matter upon which the complaint is based and took remedial action including a guaranty against loss. Respondent made no demand on the Board of Directors for any remedial action and gave no indication whether he was satisfied with remedial action that did take place. In fact, he admits he never even considered filing a demand. (Appendix D, p. 51). He never even considered the remedial action that was taken by Atlantic's Board of Directors, although a report thereon was transmitted to him approximately two months prior to the filing of his amended complaint. That such a complainant is entitled to ignore Rule 23(b) and go directly to court stultifies not only the intent and purpose of Rule 23(b) but all equitable principles upon which shareholder remedial procedures are based.

III. Failure to Follow Decisions of This Court, a Conflict in the Circuit Courts and Inconsistent Holdings in the District Courts Require Clarification of Rule 23(b) by This Court.

The decision below will create a most inequitable situation for corporations and their boards of directors. It will enable shareholders completely to evade the demand requirement set forth in Rule 23(b) and thus flood federal as well as state courts with litigation, much of which can be avoided if the Rule is reinstated to its full purpose by reversal of the decision of the Court of Appeals and reinstatement of the District Court's decision.

The complaint must show that plaintiff has made "an earnest, not a simulated effort." *Hawes* v. *City of Oakland*, 104 U.S. 450, 461. It must appear that plaintiff has done all that is reasonably expected of him; merely addressing a complaint to the board without any further attempt to induce action is not sufficient. *City of Quincy* v. *Steel*, 120 U.S. 241, 246-247; *Long* v. *Stites*, 88 F.2d 554, 555-556 (6th Cir. 1937). The complaint should show that the matters complained of were particularly brought to the attention of the directors and shareholders and that action to remedy the alleged conditions was specifically requested or demanded of them. *Isaac* v. *Milton Mfg. Co.*, 33 F.Supp. 732, 735-736 (M.D. Pa. 1940). And the filing of a complaint in court does not constitute a sufficient demand upon a board of directors in accordance with Rule 23(b). *Lucking* v. *Delano*, 117 F.2d 159, 160 (6th Cir. 1941).

If plaintiff has made no demand on the directors, Rule 23(b) provides that he must allege with particularity in his court complaint "the reasons for not making such effort." The bulk of the federal court decisions deal with this issue. The court, in passing upon the sufficiency of

the allegations, "should consider the whole complaint, not merely the paragraph in which the pleader summarizes his reasons for not demanding action by the directors or stockholders." *Cohen* v. *Industrial Finance Corp.*, 44 F. Supp. 491, 495 (S.D.N.Y. 1942). And contrary to the decision of the Court of Appeals herein, mere general averments that the directors are hostile to plaintiff or that demand would be useless and futile are not enough. *Lucking* v. *Delano*, 129 F.2d 283, 285-286 (6th Cir. 1943). And also contrary to the Court of Appeals decision herein, charges, in general terms, of Board member complicity in the wrongs complained are not sufficient to excuse a proper prior demand upon the Board of Directors. *Ziegler* v. *Lake St. Elev. R. Co.*, 76 Fed. 662 (7th Cir. 1896); *Shimer* v. *Milton Mfg. Co.*, 10 F.Supp. 943 (M.D. Pa. 1935); *Guth* v. *Groves*, 44 F.Supp 851 (S.D. N.Y. 1942).

Some courts have stated that prior demand upon directors or shareholders for remedial action will be excused in circumstances which prove that a demand would be "unavailing", "futile", or an "idle ceremony". However, the application of these nebulous criteria is a matter for wise judicial discretion. And, where, as here, testimony is before the District Court disproving such circumstances, the allegations of the complaint reciting such adjectives are clearly refuted. (Appendix D, p. 51-52.)

A conflict exists in the decisions of the Circuit Courts of Appeals with respect to the question of what constitutes proof of the futility of making a demand on shareholders. The Court of Appeals below held as follows (Appendix A, p. 24-25):

> "While the District Court did not reach that point, we see at once the futility of any such importunity upon the shareholders. With Scurlock and Sloan holding 40% of the voting stock, even without con-

sideration of the stockholdings of their associates, it would be costly business in time and money for the smaller holders to compel the corporation to protect its rights. The stock is widely distributed, and the convening of a sufficient number of the remainng 60% for a discussion and vote would certainly not be readily feasible."

Petitioners respectfully submit that, if large stockholders or a multiplicity of shareholders are a sufficient reason to excuse a plaintiff from making a demand upon the shareholders of a corporation, then a prior demand requirement would not be in the Federal Rules of Civil Procedure. It is a matter of judicial notice that there are a multitude of corporations with shareholders scattered throughout the country and the world. In *Haffer* v. *Voit*, 219 F.2d 704, 705 (6th Cir. 1955), the Court of Appeals stated that the mere fact that the other stockholders were widely scattered and that a demand upon them would involve expenses and delay, does not excuse the making of such a demand. See also *Quirke* v. *St. Louis-San Francisco Ry. Co.*, 277 F. 2d 705, 707 (8th Cir. 1960) and, contra, *Gottesman* v. *General Motors Corp.*, 268 F.2d 194, 197 (2d Cir. 1959). The Court of Appeals decision clearly conflicts with these decisions.

Furthermore, it has been held that the ownership of 40% of the voting stock of a corporation is not, as a matter of law, equivalent to full power over a board of directors, and that, in such a situation, plaintiff erred in not making a demand upon the board as a condition precedent to the maintenance of the suit. In so holding, the Court emphasized the small inconvenience in carrying out the demand requirement. *Levitan* v. *Stout*, 97 F. Supp., 105, 114-116 (W. D. Ky. 1951).

It is clear, however, that the District and Circuit Courts of Appeals have not been consistent in their holdings as to when a demand is and is not required. It has been held that, despite the allegations of the plaintiff which claim the utter absurdity of making a demand, a demand must nevertheless be made. *Squair* v. *Lookout Mountain Company*, 42 Fed. 729, 732-733 (C.C.E.D. Tenn 1890.) No case has been found, other than the opinion of the Court of Appeals herein, rejecting findings of a District Court based upon sworn testimony in favor of general allegations. It has been held that, merely because a majority of the directors are claimed to be implicated in the alleged fraud on the corporation, this does not excuse the necessity of a demand upon the entire board as a condition precedent to maintaining a suit in court. *Watson* v. *United States Sugar Refinery*, 68 Fed. 769, 773 (9th Cir. 1895). Nor will "vague and general averments of complicity on the part of the directors in the wrong against which relief is sought" bring plaintiff within the exception to the rule. *Ziegler* v. *Lake St. Elev. R. Co.*, 76 Fed. 662, 663 (7th Cir. 1896).

The decision of the Court of Appeals is in direct conflict with the *Watson* and *Ziegler* decisions, and subverts and sets aside the proper construction of Rule 23(b), as interpreted in this Court's construction of the similar equity rule in *Hawes* and *Quincy*. While these decisions pre-date the Federal Rules of Civil Procedure, there can be no doubt that those rules are a codification of the law set forth by the circuit courts of appeals in *Watson* and *Ziegler* and by this Court in *Hawes*, *Quincy*, and *Delaware & Hudson*. The District Court herein followed these decisions, and the Court of Appeals in its decision rejected them. This Court should reinstate the District Court's decision in order that the long-established rules of law, as codified in Rule 23(b), may be restored to their full intent and force in the Federal

courts, and in the state courts which follow this Rule's requirements and its purposes.

For this Court to refuse to grant the writ prayed for herein would be to abdicate its responsibility for the administration of federal procedure by allowing the nullification of the sound principle of judicial administration set forth in Rule 23(b) and further to burden the federal, as well as state, courts with a flood of unwarranted litigation.

Conclusion

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

James C. Crowley,
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APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 9201

SAMUEL MELTZER, *Appellant*,

versus

ATLANTIC RESEARCH CORPORATION, ET AL., *Appellees*.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF VIRGINIA, AT ALEXANDRIA. JOHN D. BUTZNER, JR., DISTRICT JUDGE.

(Argued January 23, 1964. Decided April 9, 1964.)

Before BRYAN and BELL Circuit Judges and MICHIE, District Judge.

ALBERT V. BRYAN, Circuit Judge:

This derivative suit by shareholder Samuel Meltzer against the Atlantic Research Corporation and its then five directors was dismissed by the District Court on the ground that the plaintiff had failed first to demand of the directors "such action as he desires" of the corporation—that is to sue for recovery of losses it suffered from the alleged misfeasance or nonfeasance of the directors. This exaction of the plaintiff was predicated on Rule 23(b), Fed.R.Civ.P. reading pertinently as follows:

> "The complaint [in a secondary action] shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort."

Appealing, the shareowner contends that a demand would have been in vain and, indeed, ineffectual if granted. We agree.

The complaint was filed on behalf of all the other shareholders. As the decision was passed on a motion to dismiss or for summary judgment, the allegations of the plaintiff are to be treated as admitted or as not genuinely in issue. So taken, they depict such misfeasance by two directors—Arch C. Scurlock and Arthur W. Sloan—and such nonfeasance by the other three as to demonstrate the emptiness of resort to them.

Scurlock and Sloan, according to the complaint, own 418,790 and 372,530 shares of Atlantic's common stock, that is 21% and 18%, respectively. It further averred that together with the other three defendant directors, Scurlock as director and president, and Sloan as vice-president and director, dominated Atlantic.

Plaintiff, a beneficial holder of stock since 1960, commenced the present action on November 13, 1962 and on January 3, 1963 filed an amendment, here treated as the complaint. He charges that on October 10, 1962 the Securities and Exchange Commission suspended the trading of Atlantic's stock on the American Stock Exchange because of the publication by Atlantic of false financial statements, including the failure to disclose certain unauthorized diversions of corporate moneys.

The misapplications were alleged as committed in 1962 and prior years. The first was the loan of $3,900,000 by Atlantic at the instance of Scurlock to "certain intermediaries". The censure is: that he had borrowed upon nearly all of his stock in Atlantic; that the market price of this stock began to decline sharply in June 1961; that as the price fell the value of the investment of the individual defendants decreased; and that in order to prevent further dwindling of their investments and to prevent shrinkage of Scurlock's security for his loans, with possible foreclosure by sale of his Atlantic shares, Scurlock and the other defendant directors determined to support the market price of Atlantic's shares. This was accomplished, the complaint declares, through the loans of $3,900,000, as the intermediaries were to use the proceeds to buy Atlantic shares on the market. This process was completed with the pledge of the newly purchased shares to Atlantic as security for the notes representing the $3,900,000.

In addition to citing Scurlock as using Atlantic's funds to defray his living, entertainment and personal traveling expenses, the complaint goes on to tax him and the other defendant directors with financing other companies in which Scurlock and Sloan were largely interested; and that these funds were used to acquire and improve land of these companies which in turn leased them to Atlantic on unfavorable terms. The complaint submits that all of these transactions were effected or brought about by Scurlock and Sloan and were participated in, or negligently tolerated by, the other defendant directors.

Injury to Atlantic is summarized in this way: that the false publication with resulting suspension by the S.E.C. of market trading in its shares gravely impaired the credit of Atlantic; that the security for the loans of $3,900,000 is substantially less in value than their face amounts; that the loans were illegal, as they were made by Atlantic to acquire its own stock; that this employment of these moneys—said to be 20% of its total assets—withdrew that sum from the intended aims of the corporation; and that these loans, as well as the appropriation of Atlantic's funds to the use of the other companies in which Scurlock and Sloan were interested, constituted "a waste and spoliation of Atlantic assets".

None of the acts or apathy of the defendants as pleaded was denied. The defense is that the directors have taken all the rehabilitative measures which could be required of them by the corporation, and this action proves the wisdom of the prerequisite of a demand before suit. The only denial is the averment of the insecurity of the loans of $3,900,000.

In this background, demand of the directors that the corporation recapture these loans and appropriations, as well as recover damages suffered by the corporation, would have been utterly unavailing. The plaintiff points out that Scurlock and Sloan with the other defendant directors dominate the Board, for they were the Board. It was too much to expect that the Board would direct the corporation to sue themselves. Furthermore, such a suit, as the plaintiff asks, would be controlled by the Board and for this

reason it is artless indeed, and faithless to the corporation, to leave the prosecution of it to the defendants therein. Cathedral Estates, Inc. v. Taft Realty Corp., 228 F.2d 85, 88 (2 Cir. 1955), 251 F.2d 340 (1957). This is demonstrated by the fact that they have already caused the corporation itself to join in the strenuous defensive moves in this suit. *Cf.* Liggett v. Roanoke Water Co., 126 Va. 22, 101 S.E. 55, 57 (1919).

The necessity and sufficiency of the preliminary demand upon the directors, and the circumstance which satisfies omission of such demand, under Rule 23(b) would seem to be procedural in nature and hence governed by Federal law. See Delaware & Hudson Co. v. Albany & Susquehanna R.R., 213 U.S. 435, 451 (1909); Quirke v. St. Louis-San Francisco R.R., 277 F.2d 705 (8 Cir.), *cert. denied*, 363 U.S. 845 (1960); but see Steinberg v. Hardy, 90 F.Supp. 167 (D.Conn. 1950). In any event, Virginia decisional law appears to be in accord. In Liggett v. Roanoke Water Co., *supra*, 126 Va. 22, 101 S.E. 55, the Court declared:

> "[U]nder the well-established and admitted doctrine . . . a stockholder may maintain such a suit for a wrongful diversion of the assets of a corporation if he alleges and proves that a request or demand has been made upon the board of directors, or other body managing the corporation, to institute proceedings against the wrongdoer, and that they have refused to do so after a reasonable request or demand, or upon the allegation and proof of such facts as shown that it is reasonably certain that a demand for corporate action would have been useless".

On the allegations of the complaint, the plaintiff is certainly also to be forgiven the omission of a request upon the stockholders to force restoration of Atlantic's losses. While the District Court did not reach that point, we see at once the futility of any such importunity upon the shareholders. With Scurlock and Sloan holding 40% of the voting stock, even without consideration of the stock holdings of their associates, it would be costly business in time and money for the smaller holders to compel the corpora-

tion to protect its rights. The stock is widely distributed, and the convening of a sufficient number of the remaining 60% for a discussion and vote would certainly not be readily feasible. *Cf.* Delaware & Hudson Co. v. Albany & Susquehanna R.R., *supra*, 213 U.S. 435, 451.

In defense, as already noted, the directors maintain that demand upon them would have achieved all of the aims of the present plaintiff. For proof they refer to the redemptive action of the Board upon learning of S.E.C.'s accusation. But this was severely wanting in satisfaction. The first step of the Board was to authorize two additional directorships, 7 instead of 5. The two directors to be added were persons not already within the corporation. However, their selection was left to the very persons now sued. The immediate result was only remotely remedial. Next, the Board authorized the creation of an executive committee consisting of three members and removed Scurlock as president. But he was immediately elected Chairman of the Board. At once Sloan was made president and the "chief executive authority over the corporation" was placed in him. Thus the very persons of whom complaint was made were retained in top rank positions.

Apart from employing a law firm to act as general counsel for the corporation, procuring a reputable accounting firm, and circulating financial statements, the only other reconstructive action of the Board was to obtain guarantees from Scurlock and Sloan of the outstanding loans of $3,900,000. These notes were impliedly admitted to be of doubtful value by the new accountant's requirement that a reserve be set up against their loss. The damage done by the loans of $3,900,000 is not cured by the guarantee of Scurlock and Sloan. Such misdirection of company funds is cured by not less than the immediate return of the money to the corporation. The action of the Board ratifies the loans rather than repudiates them. In oral argument we are told that the guarantee of Scurlock is of little value because of encumbrances upon his assets.

Again, if the defendant directors other than Scurlock and Sloan did approve these loans or were derelict in discovering or recognizing and opposing them, the corporation

undoubtedly has a claim against them for any resulting loss. O'Connor v. First Nat. Investors' Corporation, 163 Va. 908, 177 S.E. 852 (1935). All of this applies with equal force to any channeling of corporate money into other companies.

Virginia decisional law acknowledges and upholds a cause of action on the facts alleged by the appellant. Liggett v. Roanoke Water Co., *supra*, 126 Va. 22, 101 S.E. 55. This right of a minority stockholder has long been elementary in the Federal courts too. Delaware & Hudson Co. v. Albany & Susquehanna R.R., *supra*, 213 U.S. 435, 451. We do not intend to hold that the charges in the complaint are true. The only question before us is whether the facts well pleaded there excused the plaintiff from a prefatory demand upon the directors and stockholders. To repeat, we think they do.

The judgment of dismissal must be reversed, and the action remanded for trial.

Reversed and Remanded.

APPENDIX B

IN THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF VIRGINIA, ALEXANDRIA DIVISION

CIVIL ACTION NO. 2787

SAMUEL MELTZER, *Plaintiff*,

v.

ARCH C. SCURLOCK, ET AL., *Defendants*

CIVIL ACTION NO. 2788

HERBERT C. STERENSTEIN, ET AL., *Plaintiffs*,

v.

ATLANTIC RESEARCH CORPORATION, ET AL, *Defendants*

Alexandria, Virginia, May 29, 1963.

RULING OF THE COURT

The Court: Gentlemen, I first wish to thank you for the helpful way all of you have briefed and argued this case.

I think that there may be a few preliminary remarks before I take up the precise motions before us.

This is a derivative action, and the Court is fully in accord with plaintiff's counsel that the motives—as he expressed it—the motives of the parties do not of necessity destroy the action. The Court has considered it on the basis of the pleadings, and holds that merely because the plaintiffs wish to recover their loss, that it does not deprive it of its character of a derivative action. Therefore, all of my subsequent rulings are based on the holding, that we have before us a true derivative action.

Now, that does not mean to say that I have not considered their testimony. I have considered their testimony under the rule of Virginia—that a plaintiff's testimony

should be accepted when he offers it, and it binds him. He can rise no higher than it.

We have a number of collateral motions. I think they can be disposed of very briefly.

There has been a Motion to Dismiss on the ground that there is no jurisdiction because the subject matter is before the S.E.C. No authority has been cited to the Court on that, and the Court has found none. That motion is overruled. It appears that this action could be continued concurrently with the action before the S.E.C.

Probably the other collateral motion which should be disposed of at this time is that which was made generally in a number of ways; that is, an improper joinder of the defendants; that Atlantic should be the plaintiff.

In the present posture of this case, the Court believes that Atlantic has been properly joined as a defendant, and that this Court should not realign the parties, which would, of course, have the effect of defeating diversity and, consequently, jurisdiction. The Court believes that the case to which counsel have adverted, while not strictly in point, does set down the rules that governs the Court in this regard.

There have been various motions made that there is not the requisite jurisdictional amount. As counsel for both sides have very frankly stated, that is closely connected with the question of whether this is truly a class suit, a derivative action. The Court having found that it is a derivative action, the jurisdictional amount is present. The motion is denied.

The two principal motions urged before the Court today are that the plaintiffs are not stockholders of record. That is admitted as a fact. It is urged that, consequently, they do not have status to bring this suit. Of course, that conclusion is vigorously opposed.

I considered some time during the morning that possibly it would be well to take this under advisement, write a memorandum on this point and on the point concerning the demand. But I realized that from the standpoint of the parties, that time is important in this matter. You want to know where you stand. If there are appeals to

be taken, they should promptly be taken. It seems to me that the most sensible thing to do under the circumstances is to express my opinions on these matters today, especially since they have been so well briefed and well argued by counsel.

Now, taking up the question of the status of the plaintiffs, there is no doubt that that is to be governed by Virginian law. *Gallup* v. *Caldwell*, 120 F.2d 90 3rd Cir. (1941) considers this on page 93, where it said:

> "Does the applicable law require that the plaintiff be a stockholder of record? It is established that this plaintiff was not a registered shareholder, at the time the action was begun. The question is not merely a procedural one, such as whether an action may be maintained by the real party in interest who is not the owner of a legal title"—citing *Goodrich*—"but the substantive one whether one is not a shareholder of record may assert shareholder's rights either on behalf of or against the corporation. That is a question of the law of New Jersey, the state under the law of which this company was incorporated."

It is established here that this company was incorporated under Virginia law. Counsel advise the Court—I am sure you are correct—that Virginia has not passed upon this question. A stockholder or shareholder, as far as the Court could find, running through the definitions of the Virginia Corporation Act, was not defined as a stockholder of record, although there are many references in that act to a stockholder of record.

The Court understands that the majority rule in the United States is that the plaintiff in a derivative suit such as this need not be a stockholder of record. It is sufficient if he has equity position. The case cited by the plaintiff, *Rosenthal* v. *Burry Biscuit Corporation*, 30 Del. Ch. 299; 16 A. 2d 106, 1948, commends itself to the Court on this rule. There Chancellor Harrington stated:

> "After an examination of the cases and a weighing of what I consider to be the reasons behind the diverse

opinions, I have concluded that the more reasonable view—which also appears to be the majority view—is one permitting an equitable owner to maintain a derivative action.

"As this court pointed out in *Cantor* v. *Sachs*, 18 Del. Ch. 359; 172 A. 73, a stockholder's derivative suit possesses a double aspect. One aspect is the equivalent of a suit to compel the corporation to sue and the other is the suit by the corporation asserted by the stockholders in its behalf. The former belongs to the complaining stockholders while the latter belongs to the corporation. The action belonging to the corporation possesses the substantial ultimate interest since it involves the merits of the controversy. The interest of the corporation and the equitable stockholders coincided as to this aspect of a derivative action with the consequence that it is not an intra corporate matter as that term is here traditionally employed."

Now, the next paragraph of the Delaware Court's opinion answers quite well the problem that counsel for the defendants have suggested regarding the construction that this Court should put upon the Virginia Corporation Act. It has been pointed out there are many references to stockholders of record. I think Chancellor Harrington refers to most of them, although, of course, he was not speaking of the Virginia Statute.

"For many purposes, such as voting, dividend payments, and appraisal proceedings, the corporation must have a rather inflexible basis of stockholder identity. That rigidity is not needed where the equitable owner is seeking to protect the corporate interests. It places no undue burden on a corporation to permit an equitable owner to sue in such a situation because he must prove his ownership in order to maintain the action, and the need for the same certainty which prompted the courts to recognize only registered stockholders in other situations is therefore not apparent."

And then he goes on to say that his views are in accord with the views expressed by a number of other courts. In fact, he has already indicated that it is the majority rule.

Now, there is no question in this case before this Court that the plaintiffs were the equitable owners of stock. There is no controversy about the amount of stock. There is no question that stock was held in a street account. It has been suggested because the stock was held in a street account, because the rules of the various brokerage houses allow the stock to be hypothecated, brokerage houses may go short, and for other reasons, that their equitable interest in it is destroyed. Well, that, of course, is conduct of the brokerage house inherent in the street name. If, because of these peculiar situations the Court were to hold that a person whose stock might be hypothecated could not maintain an action, it would simply be holding, in other words, that stock registered in a street name could not support such a suit.

It has also been suggested that because of the plaintiffs' margin trading, that their equitable ownership is defeated.

Margin trading is a recognized form of trading. The Government approves it, controls it. The fact that stock is purchased on the margin, the Court believes, does not defeat the right to bring a suit such as this.

The Court believes that this is in accord with the majority view, although I must confess that counsel here have developed the argument much further than most of the cases have developed it. Yet, in its essentials, the issue appears no different from the question whether a person need be a stockholder of record to bring suit.

The Court probably should not concern itself with policy. But much investment money today is in street names. Much of the investment that goes on today is on the margin. This Court would be loathe to rule that in Virginia such a person does not have a right to bring a derivative suit. I doubt if the ruling of the Court would drive investment money from Virginia, but certainly it appears to me that Virginia should be in line with the other large commercial states in the country such as Delaware and New York.

That is a question of policy which can be very readily determined by the General Assembly. At the present time they have not acted on it specifically one way or the other.

We come now to the most difficult question, and that is whether the stockholders who have brought this suit have complied with Rule 23(b) of the Federal Rules of Civil Procedure. That rule states in part:

> "The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort."

Now, it is significant that the rule requires the complaint to be verified, and it is also significant that it says that "the complaint shall set forth with particularity the effort of the plaintiff—" That is a little bit different from the ordinary complaint because our rules ordinarily do not require us to set forth things with such particularity.

Turning to the Meltzer complaint, we find in paragraph 15:

> "Demand upon the board of directors of Atlantic to bring this action would be futile because:
>
> "(a) The board of directors is controlled and dominated by the alleged wrongdoers, through their official positions with Atlantic, and by virtue of their very substantial stockholdings;
>
> "(b) The directors have participated in the wrongs alleged;
>
> "(c) The directors have negligently permitted the aforementioned wrongs to occur and are liable therefor; and
>
> "(d) The institution of this action by the directors would place it in hostile hands and would prevent its effective prosecution."

In the Sterenstein complaint, we find paragraph 8:

> "No demand has been made upon the directors of Atlantic that Atlantic bring this action because such demand would be futile. The members of the Board of Directors approved of and acquiesced in such wrongs, and personally benefited thereby. They would not and could not have diligently prosecuted this action."

The Court has considered those allegations, all of the testimony of the plaintiffs and the letter to the stockholders which was brought to the attention of the Court by counsel for the plaintiff in his pretrial memorandum. Plaintiffs' counsel has asserted that the letter sets forth a great deal of the issues raised in the suits and that the plaintiffs rely upon the matters set forth in the letter to disclose the wrongdoings.

The plaintiffs have relied primarily upon two of the leading cases. Certainly, one of them is the leading case—*Delaware & Hudson Company* v. *Albany & Susquehanna Railroad*, 213 U.S. 435.

Gentlemen, let me say, parenthetically, that I am not going to attempt to recite all of the cases which you have mentioned. In stating that you rely upon a case I do not mean to in any way foreclose you. You have cited many cases in your brief, and they have been very helpful. But I tried to pick out those cases which I thought fairly typified the position that you took.

That case sustains, to a great extent, the argument made by the plaintiff. Of course, at that time the rule did not say that you should set forth with particularity the reason for failing to make the demand. That was added, possibly, as a result of that case. The Court believes, however, that the case is not controlling.

Facts were certified to the Court in that case, and among those facts was:

> "So far as appears from anything shown in this record none of the directors or officers of the Delaware Company ever, before or after the bringing of this suit,

> treated the claim therein set forth otherwise than as one of doubtful validity the payment of which was to be resisted."

Of course, this is a case that involves an interlocking directorship, so that does appear among the factors. We do not have that factual situation, in the opinion of the Court, in the case at bar.

Another case mentioned by the plaintiffs, and which is a very helpful case, is *Cohen* v. *Industrial Finance Corporation*. I should say it is mentioned by both parties. It runs throughout your briefs. 44 F. Supp. 491, Southern District of New York, 1942. There, the Court said, on page 494:

> "A realistic view should be taken of the facts pleaded as excusing a demand on directors that they bring suit. The court should not cajole itself into believing that the members of a Board of Directors elected by the dominant and accused majority stockholder, after accusations of wrongdoing have been made, were selected for membership on the Board to protect the interests of the minority stockholders and to assure a vigorous prosecution of effective litigation against the offending majority. Where we know that puppet directors would at best only go through the motions, are we barred from considering who would be manipulating the wires? As stated in the Delaware & Hudson case, supra, the rule 'is intended to have practical operation, and to have that it must, as to its requirements, be given such play as to fit the conditions of different cases.'
>
> "Whether or not a demand is excused in a particular case is a question for the Court. In passing upon that question the Court should consider the whole complaint, not merely the paragraph in which the pleader summarizes his reasons for not demanding action by the directors or stockholders."

Now I think, parenthetically, I should make it plain here so the record will be clear as to what I have done. This is a rather unique situation. Certainly, it is in this juris-

diction. Counsel have not cited any Fourth Circuit cases that are controlling. I have not only considered the complaint, but, as I have said before, I have considered the testimony of the plaintiffs and the letter to the stockholders which the plaintiffs have called to my attention and the statements in their briefs and the oral argument pertaining to the importance of that letter. So I have gone a little bit further than the Cohen case in considering the pleadings and evidence.

The Court in the Cohen case goes on to say:

> "I am of the opinion that the allegations of the complaint are adequate within the concept of Rule 23(b). Here the corporate directors of 'Acceptance' are alleged in effect to be mere 'dummies' for 'Finance.' Further the complaint shows that their interests and the interests of those who named them are antagonistic to the interests of 'Acceptance.' It is alleged that these directors 'have had knowledge of all the acts complained of herein and have acquiesced and participated therein.' It is also alleged that 'Finance,' one of the participants in the profits of the illegal transactions owns or controls 85% to 90% of the common stock of 'Acceptance,' and has voting control of 'Acceptance.' The requirement of a demand should be dispensed with, where it is clear that a demand would be a useless gesture. Indeed, in cases such as this, where other representative actions by stockholders have been 'settled,' against the real interests of the injured corporation, it would be the height of folly to entrust the conduct of the litigation, either directly or indirectly, to the very people who are responsible for the wrongs, according to the complaint.
>
> "The present directors of 'Acceptance,' with full knowledge of the facts, for years, have done nothing to protect the interests of that corporation, as the complaint alleges."

Again, the Court is of the opinion that the facts in that case do not coincide with the facts that we have before us.

Of course, facts never coincide, but in their controlling features, in their most important phases they do not reach the situation, or are not comparable, to the situation that we have here.

Now, again, there are any number of cases, which have been cited for the other side in this situation. There are Virginia cases. There are a number of Federal cases about the demand. I am not going to try to comment upon all of them. I would like to remark about *Levitan* v. *Stout*, 97 F. Supp. 105, W.D. Ky. (1951). I mention this because it has influenced my thinking about this case. I specifically asked counsel for the plaintiffs to advise me about it, which he did, and I appreciated it.

Now, that case has some factual situations similar to that which we have here. Mr. Lobell has drawn a distinction between that case and this case, which in many respects is valid. The case does, as he pointed out, concern primarily business ventures; and, as Mr. Boothe pointed out, one of them is the bourbon venture. There are other matters, however, concerning the employment contracts which the stockholders alleged were not proper.

There, the principal directors and stockholders controlled about 40% of the stock, which is very close to what we have today; and there, it was alleged:

> "* * * that demand on the Board of Directors would have been futile because three of the six directors who were in office at the commencement of the action are defendants herein and presumably would not authorize action against themselves, or permit such an action to be vigorously prosecuted if it were instituted. It is alleged that demand on the stockholders of the corporation would have been futile because the stockholders, as such, have no authority to require the Corporation to commence legal action because ownership of the 60% of stock not held by defendants is scattered; and because a proxy fight, under the circumstances, would have imposed a great financial burden on the plaintiffs."

The Court says, at page 113:

"An additional reason for granting the motion to dismiss is that the plaintiffs have failed to exhaust their corporate remedies as required by Rule 23(b) of the Rules of Civil Procedure. As has been stated above, the plaintiffs have made no effort to induce the directors or stockholders of the Corporation to bring suit. Instead, they have endeavored to demonstrate that any efforts along this line would have been futile.

"In appraising the sufficiency of the allegations on this point, the Court must take account of the fact that, for all that appears in the record, it would have been a very simple matter for the plaintiffs to make demands upon the directors and shareholders. This could have been done, for example, by simply mailing a copy of the complaint to the Board of Directors with a letter advising them that unless the Corporation enforced its rights within a reasonable time, the plaintiffs would undertake to do so on its behalf. If the Board of Directors had failed or refused to take action, the plaintiffs could have appeared at the next annual meeting of stockholders, presented a copy of the complaint, and urged the election of directors who would cause the Corporation to bring suit. * * *"

"It is well established that the courts will not take jurisdiction over intra-corporate disputes unless the ordinary corporate procedures are for some reason frustrated. * * * A stockholder, in taking stock in the ordinary corporation, submits, within the charter limits, to a guidance of the corporate affairs according to the will of the owners of a majority of the stock and through the directors whom the majority choose. The minority have a right to have the majority exercise their judgment, and to exercise it honestly and not fraudulently, but have no right to have a court substitute their own ideas and wishes for those of the majority, and that in advance of any refusal of the majority to hear and decide on the matter at issue. Minority stockholders may not in the absence of sudden emergency ask a court of equity to interfere in

the management of their corporation until they have earnestly and unsuccessfully sought redress from the Board of Directors, and where appropriate also from the stockholders in meeting, unless they can show sufficient reasons for not doing so.' "

Then the court goes on to say, at the bottom of page 114:

"Turning now to the allegations of the amended complaint in the present case, this Court must decide whether such allegations demonstrate the futility of a demand on the Board of Directors and stockholders. In the opinion of this Court, they do not. The central question is whether the ownership of 40% of the voting stock of a corporation is, as a matter of law, so clearly equivalent to full power over the Board of Directors that the directors will obey the orders of the owners of said stock—even in contravention of their own duty to act for the best interest of the corporation and despite their own responsibility for failure to do so. This Court cannot bring itself to such a conclusion."

Now, in fairness to the plaintiffs, it should be stated here that there are allegations of more than the simple control. It goes further in this case, and that is one of the things that makes this particular suit rather difficult. Quoting again from *Levitan*:

"To be sure, there are conclusory allegations to the effect that the defendants Stout and Dulaney dominated and controlled the Board of Directors, and that by reason of the scattered holdings of the other stockholders the defendants Stout and Dulaney had effective power to elect a majority of the Board of Directors."

Then the Court goes on to discuss the orderly and just procedure that Rule 23(b) sets forth and the reasons that the rule has been made.

We turn now to the peculiar situation in this case, that is the remedial action that has already been taken, the

plaintiff's testimony and the interweaving aspects of those two things.

Without going into detail about dates, I think it is a fair statement to say that almost simultaneously with the preparation of the suits, the Board of Directors had under consideration the remedial action. How long they were under consideration by both parties, we do not know. We do know that they appeared almost at the same time. The remedial actions is stated in full in the exhibit which plaintiffs have filed, under the title "Special Report to Stockholders of the Atlantic Research Corporation." Probably the most important steps that the Board took were:

To increase the Board of Directors by authorizing two new outside directors; authorizing an executive committee of three members of the Board, two to be outside directors and one of them an officer of the corporation. Dr. Arthur W. Sloan was made chairman and Rear Admiral Malcolm F. Schoeffel and James M. Johnston became the outside members. It named as general counsel the firm of Frost & Towers in Washington; arranged to retain the accounting firm of Price, Waterhouse & Co.; resolved to find a person well-versed in corporate finance; and took action respecting pledges to secure bank loans referred to in Note 13 to the Financial Statements.

These matters, I think, are also summarized and fairly stated in the Preliminary Statement filed by the defendants, on page 14 and 15. It is not controverted that the power of the president was drastically curtailed. The Board removed the President of the Company. It did assign him the position of Chairman of the Board, and it did obtain from Dr. Sourlock and Dr. Sloan a guarantee of certain outstanding loans.

Now, where this case becomes unique is that this activity was going on at the time that the plaintiffs were preparing their suits. For that reason, the question of demand becomes particularly important in this case, the Court believes.

We turn to Mr. Meltzer's testimony. He has a great deal of testimony to which I am not going to advert. It does not mean that I do not believe it, but I am just going

to pick out one part it appears to me is pertinent and unusual in this suit.

Speaking of this Special Report, Mr. Meltzer was asked a question on page 28 of the deposition:

> "When you read this report, didn't it outline remedial action which the Corporation said it had taken?
>
> "A. Yes.
>
> "Q. Wasn't it the same remedial action that you are requesting in your lawsuit?
>
> "A. I don't know. I am not sure. I didn't pay too much attention to it."

Now, it appears to the Court that if this plaintiff can say that he does not know whether the remedial action is all that he wanted, it ill behooves him to come into the court and ask the Court to tell him.

Now, casting that within the framework of Rule 23(b), it appears that there is a great possibility that if he had followed Rule 23(b) in asking for the remedial action, that even if additional remedial action were not forthcoming, he might have been satisfied in what did take place.

It also is reasonable to speculate—and it is only speculation—that if he had called other matters to the attention of the Board while they were in a reform mood, so to speak, they may have followed his suggestions. Certainly, we have not a situation here that the *Delaware & Hudson* case had. There it was certified: "So far as appears from anything shown in this record none of the directors or officers of the Delaware Company ever, before or after bringing this suit, treated the claim therein set forth otherwise than as one of doubtful validity * * *."

Here the Board has given this matter some concern.

Now, it is true, the Court recognizes, that the Board has not given all of the relief that the plaintiff seeks, but that is not the question before us on this motion. The question is whether Rule 23(b) has been complied with, or whether the allegations set forth are sufficient to excuse the effort.

It also demonstrates that the situation is not the same

as that in the Cohen case where the evidence was that the directors, with full knowledge of facts, for years had done nothing to protect the interest of the corporation, as the complaint alleges. In that case also, there have been other demands made by other stockholders.

Now we come to Mr. Sterenstein's testimony, and he is essentially in the same position as Mr. Meltzer, but he cannot say, for a very good reason, whether the remedial action taken would have been satisfactory to him. He was asked on page 46—the question was:

> "I am speaking of demand upon this Corporation or its stockholders or directors.
>
> "A. I made no demands, no sir.
>
> "Q. Did you receive a special report from the Corporation with respect to the S.E.C. Investigation?
>
> "A. To the best of my recollection, I did not receive it.
>
> "Q. Have you ever seen it?
>
> "A. I do not think I did see it."

Now these complaints were probably prepared before the report. Counsel may be able to help me on that. I do not want to misstate any facts, but as far as I can determine, these things must have been going along fairly simultaneously. Certainly, the suit had been filed by the time that Mr. Meltzer saw the report.

Now, Mr. Sterenstein is essentially in the same position, and Mrs. Sterenstein.

He cannot say whether the action which he sought would have been better or not, or whether it has been met. Of course, I make this comment upon the testimony with full realization that they are still prosecuting the suit, but in making that comment I must also take into consideration that they have said time and again that they know very, very little about this, and they have left it up to their attorneys. It was the duty of the attorney to prosecute the suit diligently. But the Court cannot measure the plaintiff's rights by the action of the attorneys.

Counsel have urged me to rule on the question of whether the plaintiffs should have made a demand upon the stock

holders. The Court believes that it is impossible to rule at this time because of the absence of a demand upon the directors. It is impossible to say whether or not a demand upon the stockholders should or should not have been made until the plaintiffs had gotten their answer from the directors. The Court believes that that is the fair purport of that rule.

The Court believes that the rule which states, "and, if necessary, from the shareholders," means that they should apply to the shareholders if they had not gotten results from the directors. So the Court is not going to rule at this time. There is nothing to rule on.

The Court is of the opinion that Rule 23(b) has not been complied with.

Now, we have some other motions, and they pertain to service of process. As counsel have frankly stated, those motions are interwoven with whether the complaint states a cause of action. We did not get into the motion on process in the way I would like to have it gone into in order to rule on it. Mr. Morgan stated he never heard of the exact basis of the complaint until Mr. Lobell spoke about it in what was essentially rebuttal argument. Then Mr. Morgan wanted me to take into consideration a case which was not cited and which Mr. Lobell had no opportunity to read and comment upon. I just do not like to decide cases that way. Because of the peculiar situation in which we find ourselves, I think we will defer ruling on that. It is not necessary for the disposition of this case. If the case should come back to me, why, of course, we will have to rule on it. I must confess I did not realize how closely it was tied with whether or not the complaint states a cause of action until I heard the oral argument today. I have not considered the case which Mr. Morgan says is controlling. I will not consider it unless Mr. Lobell has a chance to tell me it is not controlling.

I think what I have said disposes of the case. What I have tried to do is rule on the most important motions so if counsel wish to assign error and cross-error they may do so.

Is there a request for any other ruling?

Mr. Lobell: Your Honor, because of the gravity of your views insofar as they affect the complaints with respect to Rule 23(b), I wonder if my client could tax your indulgence by pointing out some reasons why we can't perhaps comport with your views on the one hand; nevertheless, avoid a dismissal of the action at this time.

Your Honor is quite correct, I think, in assuming that these complaints were worked on at the same time that the directors worked on this special notice to the stockholders, but it should be obvious from the fact I was the one that attached that special report to my memorandum, urgently to bring to the attention of the Court that had it been under my notice at the time this complaint was being prepared the complaint still would have been prepared.

I don't want to argue law. I want to point out, however, Your Honor, that despite the fact that in *Levitan* v. *Stout* you do have a suit involving only three out of a large Board of Directors, to assume that the directors not sued would do their job if the matter were brought to them, it might be too much for the Court to assume. It is not going to make any such assumption about these people for the purpose of a procedural motion, but, Your Honor, it is a fact that the Board of Directors, each member of the Board of Directors, is a defendant in this case, and it seems to me that, again, to expect that it could be a meaningful act for the plaintiffs and plaintiff's counsel to ask these gentlemen to sue themselves would be too much.

In the complex of this case, would it be possible, Your Honor, for me at this time on behalf of the plaintiffs to make a demand, via counsel, upon the Board of Directors, upon the company, that it bring this action, or join us in this action? I was serious in trying to point out to Your Honor that in the Liggett case *Liggett* v. *Roanoke*, in this jurisdiction of Virginia, the resistance of the corporation to the action was a sufficient indication that the demand would be futile. If demand has any meaning whatsoever, I earnestly would like to have the help of corporate assets, corporate facilities in pursuing this action.

I make the demand now.

Wouldn't it be feasible, instead of moving any further in this action, to give the Board of Directors an opportunity to consider this demand; and I make it in good faith, in the same good faith on which the Court has ruled on the procedural motions here; and perhaps we can have them join us. If they refuse to, why can't the action still go on? If they join us, we will have a better action.

It seems to me that Your Honor is quite correct in trying to preserve the effect of Rule 23(b) in not taking the matter of demand lightly, and it seems to me that Your Honor's views can be met fully by the mere device of my transmitting, via counsel, to the company the request that they bring this action. If they have suggestions for an amendment of the action which would fruitfully pursue the maximum rights for the corporation, for the shareholders, we will consider that very carefully.

I had, in fact, Your Honor written in my notes for oral argument this morning, this very same plea: to turn around to counsel and say: "Would it not lie better with you to give us your help and your facilities so that the Corporation and other shareholders will join us?"

I make it now. If it was my fault not to have made it then, I make it now. I make it in seriousness, that it give the Corporation and the directors time in which to consider this earnest request, or any variant of it, and then let's come back to you and see whether or not in substance, we have in effect complied with 23(b).

Mr. Koutoulakos: I thought Your Honor had ruled on the motion, had made the decision.

The Court: Well, I have ruled, and counsel has made a motion. I will have to rule on the motion. I would be glad to hear from counsel on it.

Mr. Morgan: If Your Honor please, I think there is a simple answer. This is a condition precedent to bringing an action. If counsel feels they did not follow the correct procedure, they want to start that procedure in view of the ruling, and in view of those cases, let them start the procedure. They may have to first go to the directors, and they may get something to satisfy them. Again, they may not. They may have to go to the stock-

holders, and if they then are not satisfied, the courts are always open. They can file another suit, but there is no reason to hold this suit—when the conditions precedent were not met, and clearly not met—to hold this suit in abeyance.

I don't know that doing anything now could ever cure the defect. It is a condition precedent. They would be better off to do whatever they think they should do. If they still think they have a cause of action, the Court is always open for the filing of a complaint.

The Court: Well, Mr. Lobell did mention he was confident that the Board would not do anything—bring any suit. Actually, the Board has secured guarantees. I have not added up the money, but it does run into hundreds of thousands, something over a million dollars, from these very wrongdoers.

Gentlemen, I have not passed upon the merits of this case. I have tried to keep the merits out of my mind. I did not try and decide the motion on the merits and have the case come out on the motion the way I think it should come out on the merits. I do not want any confusion in what I am going to say about Mr. Lobell's motion.

What he has essentially made is a plea to get on with the merits because the merits deserve it. Whether or not they deserve it, I am not going to pass on them at this time.

The Court believes that Rule 23(b) was enacted, as Mr. Morgan said, as a condition precedent. It was enacted so that before people were brought to court, without compulsion of a court suit, they could sit down and either accept a man's demands, make counter proposals, negotiate, carry on the affairs of a corporation within the corporation.

Now, the Court believes that the purpose of the Rule would be defeated if demand were made during the pendency of a suit, because the plaintiffs would simply be in a position of saying, "Here is a demand; if you don't like it, we will ask the Judge to go along with the merits of the case."

Now that is not a healthy way to litigate. The Rule itself says, "The complaint shall set forth with par-

ticularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholder, such action as he desires, and the reasons for his failure to obtain such action or the reasons for not making such effort."

The Court believes that you cannot give pending suit the type of demand the rule contemplates. It is to secure from the directors the action which he seeks. It is spoken of as a demand, and maybe in some of these suits it is not a simple demand. In some of the suits where they simply made a demand and let it go at that, the Court has held that was sufficient. Those cases have been cited in the briefs. I am not going to rule on what is a requisite demand. We do not have that question before us. But I am confident that to grant Mr. Lobell's motion would be contrary to the language of the rule, and contrary to the spirit of the rule. These matters should first of all be worked out within the corporation before they become involved in the procedures of a lawsuit.

The motion is denied.

Mr. Lobell: Your Honor, you have been more than indulgent and patient in your effort to explain your action. I am, however, very troubled now as to how we go on. The essence of my action is that not merely Mr. Scurlock, but those who constituted the management, have been at fault. If my action was solely against Mr. Scurlock, I probably could do no better, certainly, at this time, than the Board of Directors have done.

Now, it is not for the purpose of rounding out a series of names that we have named the directors as defendants. It is because we believe there is sufficient warranty to believe, and the possibility of showing, either willful or negligent condolence of the actions of Mr. Scurlock and others.

Now, if I must make demand, Your Honor, I am being asked to demand of these directors that they sue themselves. There is no point in my rearguing the case. The case has already been argued, but what I am trying to understand, Your Honor, is how, and in what meaningful way, assuming that I wish the action to be tried for good

or bad, for better or worse, as I want it tried. I want the liability of these people, each one of them, appraised and assessed in the light of the best evidence that we can adduce as to actually what they knew what they didn't know, what they participated in, what they didn't participate in.

The Court: Mr. Lobell, let me —

Mr. Lobell: Now, shall I ask them to bring this action against themselves; and is there a possibility that they can conceivably say yes; and if they say no, where am I?

The Court: Mr. Lobell, the argument you make is really against Rule 23(b). Please understand I am not denying you to have this case heard on the merits. I am insisting that the case follow what I conceive to be a very important Rule of Federal Procedure, and I have come to the conclusion that it did not follow that rule.

Now, gentlemen, is there anything further?

I will ask that an order be prepared by counsel. It need not be endorsed by all counsel for the defendants, although they may do so if they care to. It certainly should be submitted to Mr. Lobell for his endorsement.

Mr. Koutoulakos: Your Honor, I understand the ruling to mean that they haven't complied with the substance of Rule 23, which means that their matters are dismissed for failure to comply.

The Court: That is right. The Court has dismissed the case for failure to comply with Rule 23(b).

Now, I would like you to get the order to Mr. Lobell and send it down to me. I would like all of these matters to be contained in one order; not just simply an order dismissing. I have ruled on the fact that the plaintiffs have status as shareholders. I would like that ruling to be shown in the order. I denied that motion.

Mr. Lobell: Your Honor, can we understand that this dismissal is without prejudice to the bringing of this action by these plaintiffs, or others, upon compliance with the rule?

The Court: Yes, sir.

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

No. 9201

SAMUEL MELTZER, *Appellant*,

v.

ARCH C. SCURLOCK, ARTHUR W. SLOAN, JAMES M. JOHNSTON, MALCOLM F. SCHOEFFEL, FRANKLIN C. SALISBURY, AND ATLANTIC RESEARCH CORPORATION, *Appellees*.

ORDER DENYING REHEARING

Upon consideration of the petition of the appellees for a rehearing, the Court is of the opinion that no adequate ground is shown for a reconsideration of this appeal, and accordingly it is

ORDERED that the said petition be, and it is hereby, denied.

ALBERT V. BRYAN,
United States Circuit Judge.

J. SPENCER BELL,
United States Circuit Judge.

THOMAS J. MICHIE,
United States District Judge.

FILED MAY 21, 1964, MAURICE S. DEAN, Clerk.

MAY 20, 1964.

A true copy,

Teste:

MAURICE S. DEAN,
Clerk, U. S. Court of Appeals for the Fourth Circuit.

By MARGARET L. DAVIS,
Deputy Clerk.

APPENDIX D

Excerpts from Deposition of Samuel Meltzer Taken by and Before Frances G. Webb, Notary Public in and for the State of Virginia at Large, in Room 229, Post Office Building, Alexandria, Virginia, on Tues., March 12, 1963, Commencing at 11:15 O'clock A.M.

* * * * * * *

[7] Q. How long did you work for Walston & Co.? A. About 14 months, I would say.

Q. Dating from when to when? A. January 2, 1962, to February 28, 1963.

Q. By whom were you employed prior to your employment with Walston & Co.? A. I was not employed by anybody.

Q. What kind of work did you engage in? A. I was a professional musician.

Q. Were you a professional musician throughout your working life up until the time you went to work for Walston & Co.? A. That is correct.

Q. What kind of work did you do for Walston & Co.? A. I was an accounts executive.

[8] Q. What does an accounts executive do? A. Well, they used to call us a customer's man.

Q. What does a customer's man do? A. A customer's man buys and sells stock, acts as a broker.

* * * * * * *

Q. When you purchased the 50 shares of Atlantic Research Corporation stock on September 21, 1960, is it your testimony that you purchased that on a margin account? A. That is correct.

* * * * * * *

[14] Q. Have you bought any Atlantic Research stock other than these 50 shares and the 100 shares which you bought in December 1962 over this period? A. No; that is all.

Q. This is the entire amount of Atlantic Research stock? [15] A. Of course, those 50 shares are now 100.

Q. Because of the split? A. Yes; so that is 200.

* * * * * * *

[18] Q. Do you recall where you signed the complaint in this case? Was it in Mr. Gurkin's office? A. No. It was in my home.

Q. Was that signed before a Notary? A. Yes.

Q. Who was the Notary? A. Well, I cannot tell you his name, but I can tell you it was a drugstore situated on the corner of East 18th Street and Church Avenue, Brooklyn.

Q. Why were you signing it at your home? A. Why was I signing it at my home? Because it was Saturday and I was not in my office.

Q. So that would be Saturday, November 10, 1962; do you recall that? A. I don't know exactly the date, but—

Q. Do you know whether or not you signed this before or after you received the special report to stockholders by the Atlantic Research Corporation? [19] A. Special report?

Q. Yes. A. Am I to understand this, that—I know that Atlantic Research had sent out a report much later explaining the entire thing. Is that what you are referring to?

Q. That is what I am referring to. A. No. I signed the complaint before that.

* * * * * * *

Q. Did you contact any officer of Atlantic Research Corporation about the information you had seen in the newspapers? [20] A. No, I did not.

Q. Did you contact any director of Atlantic Research? A. I contacted nobody in Atlantic Research. I contacted nobody.

* * * * * * *

[21] Q. When you contacted your counsel, did he suggest to you that you contact Atlantic Research for an explanation of this matter before you filed a lawsuit? A. No. It was not necessary. The whole story was known to everybody by the press.

Q. He did not suggest to you that you make a demand upon the officers or directors or the stockholders of Atlantic Research? A. No, he did not.

Q. Did he say anything to you about making such a demand and waiting 60 days before filing your lawsuit? A. Not that I recall, no.

Q. This demand was not discussed at all, then? A. No, sir.

* * * * * * *

[24] Q. Is it your impression that the loans referred to as having been made by Atlantic Research, which are the basis of your complaint are unsecured loans? A. I am not sure.

Q. Is it your impression that they are in default? A. I haven't any idea.

Q. So you do not really know whether Atlantic Research has suffered any damage? A. To what extent?

Q. I am asking you. Do you know of any actual financial or other damage that Atlantic Research Corporation has suffered? A. No, I do not.

Q. Was it your decision not to contact the Corporation or its officers and directors and other stockholders before filing this lawsuit, or just whose decision was it? A. It was my decision.

Q. And you say you did not even discuss it with your attorneys? A. No.

* * * * * * *

[26] Q. Did you read the special report to stockholders between the time that you filed your complaint and the time you filed your amended complaint? A. Well, I glanced through it, that is about all, because it was nothing but a repeat, actually, of what I had seen in print.

Q. Was that report mailed to you? A. It was.

Q. By whom? A. The individual? By Atlantic Research.

Q. Was it mailed to you by Atlantic Research? A. That is right.

* * * * * * *

[27] Q. I think I have asked you this once before, but I want to be sure that I have.

You made absolutely no effort to secure from either [28] the corporate officers or directors or the stockholders the remedial action you request in your complaint? A. No, I did not.

Q. When you read this special report to stockholders, didn't you conclude that the Corporation had taken remedial action, the very action you were asking for in your complaint?

MR. SILVERMAN: I object. That calls for a legal conclusion and I do not think the witness is capable of giving that, and I instruct the witness not to answer the question.

Q. When you read this report, didn't it outline remedial action which the Corporation said it had taken? A. Yes.

Q. Wasn't it the same remedial action that you are requesting in your lawsuit? A. I don't know. I am not sure. I didn't pay too much attention to it.

APPENDIX E

IN THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF VIRGINIA, ALEXANDRIA DIVISION

Civil Action No. 2787

SAMUEL MELTZER, *Plaintiff*

v.

ARCH C. SCURLOCK, ET AL., *Defendants*

Affidavit of the Secretary of Atlantic Research Corporation

CITY OF WASHINGTON

District of Columbia, ss:

Franklin C. Salisbury, being duly sworn, deposes and says that:

1. He is the Secretary of Atlantic Research Corporation and has been such at all times here pertinent;
2. Among other duties, he is charged with keeping the minutes of meetings of the board of directors; and
3. The following are true and accurate excerpts from duly approved minutes of meetings of the board held on the dates specified:

October 14, 1962

In order to restore the Company's position with the Securities and Exchange Commission and to mitigate the irreparable damage that the aforesaid Order has been causing the Company, its employees and stockholders and the resulting interference with the performance of its defense contracts, the Board of Directors unanimously adopted the following resolution:

> RESOLVED, That an agreement be prepared for execution which will guarantee payment of the outstanding loans due Atlantic Research Corporation

from Texas Capital Investments, having a balance of $1,701,913; from Pine Ridge Corporation of $969,000 and from Smith Corporation of $1,200,000, this agreement of guarantee to be executed by certain of the Directors, having an aggregate net worth in excess of said outstanding accounts.

October 28, 1962

After further discussion and upon motion duly made and seconded, the following resolutions were unanimously adopted:

RESOLVED, that the Corporation accept from its two principal stockholders, Dr. Arch C. Scurlock and Dr. Arthur W. Sloan, the guarantee signed by them on October 18, 1962, for payment of certain outstanding loans to secure the Corporation against loss in case these loans should prove uncollectible.

October 31, 1962

The following resolutions were duly made, seconded and unanimously adopted:

RESOLVED, pursuant to Article 4, Section 9 of the By-Laws, that Messrs. Arthur W. Sloan, James M. Johnston, and Malcolm F. Schoeffel are hereby appointed to be the members of an Executive Committee commencing October 31, 1962, to hold office until the next annual meeting and until the respective successors are appointed.

FURTHER RESOLVED, that Dr. Arthur Sloan shall be the Chairman of the Executive Committee.

FURTHER RESOLVED, that the Executive Committee will meet not less than once each two weeks.

The following resolutions were made, seconded, and adopted. Dr. Scurlock requested to be shown as voting against all four of them. He wished to be recorded as being opposed to the creation of an Executive Committee

(although the Committee is provided for in the By-Laws) and to the granting to it of the broad powers as adopted in the following resolution. It was his opinion that the Board as a whole could fulfill its responsibilities without the use of an Executive Committee, and he, as a member of the Board, was not willing to turn over any of his policy-making authority to others, at this critical time, when the responsibility for Company policy necessarily resides with the Board.

With respect to the resolution limiting the powers of the President, Dr. Scurlock expressed the opinion that such limitations are contrary to sound procedures in corporate management, in that they require the specific authorization of the Executive Committee or the Board with respect to matters arising in the ordinary course of business. He stated that he was not opposed to placing some limitations on the powers of the President in regard to matters not in the ordinary course of business, but he felt that such limitations could be imposed by the Board without amending the By-Laws.

With respect to the Resolution requiring the "new employee having a financial background" to report to the Executive Committee, Dr. Scurlock expressed his opposition to having such financial person report to the Executive Committee on the grounds that it was bad corporate practice.

RESOLVED, that the said Executive Committee shall have all the powers and exercise all the duties of the Board between meetings of the Board, in the management of the business of the Corporation, all such actions to be subject to ratification by the Board of Directors except where damage to third parties might occur by failure of such ratification.

FURTHER RESOLVED, that the "Powers of the President" of the Corporation be changed to limit the powers of the President strictly to normal operations of the Company. The President shall have no power to draw checks, commit the corporation's funds, or take any actions regarding the Company's finances

without specific authority of the Executive Committee of the Board.

FURTHER RESOLVED, that the President report directly to the Executive Committee.

FURTHER RESOLVED, that the proposed new employee having a financial background, if and when one is employed by ARC, shall report directly to the Executive Committee.

November 7, 1962

After further discussion and upon motion duly made, and seconded, the following resolution was adopted:

RESOLVED, that Company special counsel be authorized and directed to enter into a stipulation of facts agreeable to the SEC for the purpose of effecting a lifting of the "suspension order" prohibiting trading in the Company's shares.

No stipulation in final form was available at this meeting for review by the Board of Directors.

On this resolution, Dr. Saurlock, President of the Company refrained from voting on the grounds that the Commission's "Statement of Matters to be Considered in a Hearing Pursuant to Section 8 (d) of the Securities Act of 1933" (1) unfairly characterizes various transactions and imputes motives in connection therewith which have not been established, and are not correct; (2) not only purports to recite facts, but also raises questions which would normally be determined at a hearing, and the stipulation may be interpreted as acceding not only to factual statements but also to an adverse determination of the questions posed; (3) includes recitals of facts not within his knowledge as well as several inaccuracies as to factual details, and (4) his concurrence in the stipulation might be interpreted as an admission by him that his actions have involved violations of laws, which he denies.

November 8, 1962

RESOLVED, that counsel be authorized to execute the "stipulation" prepared by personnel in the Division of Corporate Finance of the Securities and Exchange Commission arising from the private investigation presently being conducted by the Securities and Exchange Commission.

Dr. Scurlock refrained from voting on the grounds that the "facts" as stated from time to time by the Securities and Exchange personnel to Company counsel are not in fact correct and his concurrence in such stipulation might be interpreted as an acknowledgment by him that his acts were in violation of the law, which he denies. Further, he stated that his grounds for refraining to vote on the motion were the same as expressed with respect to his vote at the November 7, 1962 meeting.

November 21, 1962

Mr. Franklin C. Salisbury thereupon stated that he believed the Board of Directors should consider a change in corporate responsibilities of the officers. He therefore proposed not by way of punitive action but in order to rationalize and improve corporate management, that the offices of Chairman of the Board, President, and Executive Vice President be declared vacant and that the By-Laws of the Corporation be amended—the exact wording to be supplied by Company counsel and incorporated as part of the minutes of this meeting—to create the new offices of Vice Chairman of the Board and Chief Executive Officer of the Company. He stated that he further recommended that the following persons be then nominated to fill the vacancies thus created: Chairman of the Board, Dr. Arch C. Scurlock; Vice Chairman and Chief Executive Officer, Dr. Arthur W. Sloan; and President, M. Lee Rice. Dr. Scurlock argued against the suggestion. However, it was pointed out that this new slate of officers would preserve the talents and progressive abilities of Dr. Scurlock

for the Company, bring to play the maturity of Dr. Sloan to the day to day activities of the Company and call upon the administrative abilities of Mr. Rice, as President. After further discussion, and upon motion made by Mr. Salisbury, and seconded by Admiral Schoeffel, the following resolution was adopted by a vote of five to one (Dr. Scurlock voting "No").

> RESOLVED, that the offices of Chairman of the Board, Executive Vice President and President be declared vacant.

The following resolution was thereupon unanimously adopted:

> RESOLVED, that the By-Laws of the Corporation be amended to create the positions of Vice Chairman of the Board and Chief Executive Officer of the Company.

The Secretary was ordered to complete the appropriate amendment to be made part of the minutes of this meeting.

Thereupon the above motion having been unanimously carried, the following were nominated for the offices set after their names: Arch C. Scurlock, Chairman of the Board; Arthur W. Sloan, Vice Chairman and Chief Executive Officer, and M. Lee Rice, President. Upon motion duly made and seconded each of the above officers was elected by a unanimous vote . . . Dr. Arch C. Scurlock and Dr. Arthur W. Sloan not voting in connection with their own election.

s/ FRANKLIN C. SALISBURY,
Franklin C. Salisbury.

Subscribed and sworn to before me this 29th day of April, 1963

s/ DOROTHY B. WOODHEAD,
Notary Public.

My commission expires Nov. 14, 1963.

APPENDIX F

Excerpts of Special Report to Stockholders of Atlantic Research Corporation

November 9, 1962.

ATLANTIC RESEARCH CORPORATION

TO THE STOCKHOLDERS OF ATLANTIC RESEARCH CORPORATION:

[3] On October 10, 1962 the U.S. Securities and Exchange Commission, acting under Section 19 (a) (4) of the Securities Exchange Act of 1934 suspended trading of Atlantic Research Corporation stock on the American Stock Exchange, the Philadelphia-Baltimore-Washington Exchange and in the over-the-counter market, for the statutory period of ten days. Since that time, successive renewals of that Order have been entered by the Commission. Now a further order is being entered today which we expect to be lifted after appropriate time for dissemination to stockholders and the public of information furnished in this and accompanying documents has passed.

The Commission's first public release stated that its Suspension Order presented no question of the Company's solvency but did allege that serious questions had been raised as to the accuracy and adequacy of available, public information concerning the financial condition of the Company.

The Board of Directors of Atlantic Research, to which the Commission's Order came as a shock, reacted as promptly as possible, taking at once the following specific actions:

(a) It appointed a Finance Committee, consisting of Directors James M. Johnston and Dr. Arthur W. Sloan, who were authorized and directed to supervise all financial affairs of the Corporation other than those affecting the day-to-day routine operation of the Corporation. This Committee was also charged with investigation of certain criticized loans and directed to make recommendation of a proper reserve, if any reserve were required, against prospective losses on said loans; and

(b) It retained a firm of Washington, D.C., lawyers that practice before the SEC to represent the Company in connection with all pending SEC matters.

* * * * * * *

Subsequent to the October 10, 1962 Order it was alleged that during the period November 1961 to July 1962 certain officials of the Company caused substantial amounts of corporate funds to be employed for purchase of the Company's common stock in the open market and otherwise without Board approval and without public disclosure. An investigation by the Finance Committee disclosed that commencing in August 1961, without authority from the Board of Directors, the President of the Company, Doctor Arch Scurlock, authorized loans to individuals and corporations, part of the proceeds of which were used to purchase the common stock of Atlantic Research Corporation.

* * * * * * *

[5] After being apprised of the above transactions the Directors, among other steps, took the following further actions:

1. Increased the Board of Directors by authorizing two new outside Directors, making the Board membership seven instead of five. The names of newly selected Directors will be publicly announced in the near future.

2. Authorized and selected an Executive Committee of three members of the Board, two to be outside Directors and one an officer of the Corporation. Dr. Arthur W. Sloan was made Chairman of this Executive Committee and Rear Adm. Malcolm F. Schoeffel, U.S.N. (Ret.) and James M. Johnston became the outside members. This Committee has been given very broad powers and provision has been made that it shall meet not less than once each two weeks.

3. Named as outside General Counsel for the Corporation the law firm of Frost & Towers, Southern Building, Washington, D.C.

4. The Board has held preliminary conferences with and has arranged to retain the accounting firm of Price, Waterhouse & Co. as independent Certified Public Accountants for the Company with the request that they audit the Company's accounts through a current date and later for the full calendar year 1962. Their responsibility will begin on November 9, 1962. These accountants are directed to report to the Board of Directors. This change in accountants is not intended to be a reflection on the existing accounting firm.

5. Resolved to find and engage as soon as possible a person well-versed in corporate finance who, in the judgment of the Board, has qualifications to be appointed as a Vice President for Finance or Treasurer.

6. Took the action respecting pledges to secure bank loans referred to in Note 13 to the Financial Statements.

Since first receipt of the Order of October 10, 1962, it has been the determination of the Board to disseminate all information deemed pertinent and necessary to fully inform stockholders and the public as quickly as possible. Hence, the Board directed its outside Certified Public Accountants to take the following action:

(a) To restate the financial statements of December 31, 1960 and 1961 to show the Company's financial position with investments of subsidiaries converted to an equity basis;

(b) Prepare financial statements (Company figures not certified by outside CPAs) showing the financial position of Atlantic Research as of June 30, 1962, wherein the following adjustments are made:

1. To establish a reserve for possible losses on notes receivable of $1,500,000, less applicable Federal taxes of $810,000, making a net figure of $690,000;

[6] 2. To make provision for anticipated losses on Government contracts in process by the two hereinbefore-named subsidiaries. This amount, as explained in Note 4 to the financial sheets, was fixed at $850,000;

3. To write off cost in excess of net asset value from the acquisition of General Communication Company, acquired January 2, 1962. Under normal accounting practice in consolidation this difference would have been carried on the Corporation's accounts as "good will"; but in view of operational losses of this subsidiary it was determined to write off the entire figure.

In connection with the reserve for possible loss on notes receivable the newly created Finance Committee has obtained additional security for the loans in question by obtaining a contract of guarantee against loss from such loans from Dr. Arthur W. Sloan and Dr. Arch Scurlock, who own approximately 40% of the issued and outstanding stock of Atlantic Research. Also, it has obtained a Deed of Trust on certain real estate which under all circumstances involved would seem to give added protection to the extent of $700,000; and, a pledge of the interest of Texas Capital Investments, Inc. in the Atlantic Research Corporation stock owned by it. The Atlantic Research stock owned by Dr. Scurlock and Texas Capital Investments, Inc., is pledged with various banks and brokerage firms.

* * * * * * *

Atlantic Research Corporation is solvent, expects to fulfill its contractual obligations and vigorously pursue its normal operations particularly in the field of National Defense. It is hoped that there will be a sufficient interval between your receipt of the information contained in these papers and the actual resumption of trading for you to give careful study thereto.

By Order of the Board of Directors,
Atlantic Research Corporation,
Dr. Arthur W. Sloan,
Chairman, Board of Directors.

Office-Supreme Court, U.S.
FILED
AUG 21 1964
JOHN F. DAVIS, CLERK

IN THE

Supreme Court of the United States

October Term, 1964

No. 319

ARCH C. SCURLOCK, JAMES M. JOHNSTON and MALCOLM F. SCHOEFFEL,

Petitioners,

v.

SAMUEL MELTZER,

Respondent.

No. 326

ARTHUR W. SLOAN, FRANKLIN C. SALISBURY, and ATLANTIC RESEARCH CORPORATION,

Petitioners,

v.

SAMUEL MELTZER,

Respondent.

BRIEF FOR PLAINTIFF-RESPONDENT IN OPPOSITION TO PETITIONS FOR CERTIORARI

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INDEX

	PAGE
QUESTION PRESENTED	2
STATEMENT OF THE CASE	3
1. The amended complaint	3
2. Other matters before the District Court	5
ARGUMENT	7
POINT I—The Petitions Present No Question of Federal Law	7
POINT II—The Decision Below Presents No Question of General or National Interest	9
POINT III—The Decision Below Is Not in Conflict With Other Authorities	12
CONCLUSION	13

TABLE OF CITATIONS

Cases:

Brown v. Bullock, 194 F. Supp. 207, 228 (SDNY, 1961), aff'd 294 F. 2d 415 (Cir. 2, 1961)	10
Carroll v. N. Y., N. H. & H. R. Co., 141 F. Supp. 456, 457 (D. Mass., 1956)	8
Carruthers v. Jack Waite Mining Co., 14 F. R. D. 475 (SDNY, 1953)	8
Guth v. Groves, 44 F. Supp. 851 (SDNY, 1942)	12
Halprin v. Babbitt, 303 F. 2d 138 (Cir. 4, 1962)	8
Hausman v. Buckley, 299 F. 2d 696 (Cir. 2, 1962)	8
Hawes v. Oakland, 104 U. S. 450 (1882)	8

PAGE

Levitt v. Johnson, CCH Fed. Sec. Law Reporter, Sec. 91413, p. 94641 (Cir. 1, Op. No. 6249, July 8, 1964, not yet officially reported) 10

Levitan v. Stout, 97 F. Supp. 105 (W. D. Ky., 1951) ... 12

Pomerantz v. Clark, 101 F. Supp. 341 (D. Mass., 1951) 8

Shimer v. Milton Mfg. Co., 10 F. Supp. 943 (M. D. Pa., 1935) 12

Squair v. Lookout Mountain Co., 42 Fed. 729, 732-3 (E. D. Tenn., 1890) 12

Steinberg v. Adams, 90 F. Supp. 604, 609 (SDNY, 1950) 8

Steinberg v. Hardy, 90 F. Supp. 167, 169 (D. Conn., 1950) 8

Swanson v. Traer, 354 U. S. 114 (1957) 7

Swanson v. Traer, 249 F. 2d 854 (Cir. 7, 1958) 8

Toebelman v. Missouri-Kansas Pipe Line Co., 41 F. Supp. 334 (D. Del., 1941), rev'd 130 F. 2d 1016, 1022 (Cir. 3, 1942) 8

Tower Hill-Connelsville Coke Co. v. Piedmont Coal Co., 64 F. 2d 817 (Cir. 4, 1933) 12fn

United States v. Employing Plasterers Ass'n, 347 U. S. 186, 188 (1954) 10

Watson v. United States Sugar Refinery, 68 Fed. 769, 773 (Cir. 3, 1895) 12

Ziegler v. Lake St. Elev. R. Co., 76 Fed. 662, 663 (Cir. 7, 1896) 12

PAGE

Statutes and Regulations

Federal Rules of Civil Procedure—Rule 23(b) 2, 10, 12
Equity Rule 94 (104 U. S. IX) 12
Equity Rule 27 (226 U. S. 656) 12

Administrative Decisions

Matter of Atlantic Research Corporation (S. E. C. Dec. 6, 1963, Securities Act Release No. 4657) 4

IN THE

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No. 319

ARCH C. SCHERLOCK, JAMES M. JOHNSTON and MALCOLM F. SCHOEFFEL,

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v.

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Respondent.

No. 326

ARTHUR W. SLOAN, FRANKLIN C. SALISBURY, and ATLANTIC RESEARCH CORPORATION,

Petitioners,

v.

SAMUEL MELTZER,

Respondent.

BRIEF FOR PLAINTIFF-RESPONDENT IN OPPOSITION TO PETITIONS FOR CERTIORARI

Plaintiff-respondent submits this brief in opposition to the petition for certiorari of defendants Sloan, Salisbury and Atlantic Research Corporation ("Sloan petition") and the separate petition for certiorari of defendants

Scurlock, Johnston and Schoeffel ("Scurlock petition"). Both petitions seek review of a decision of the Court of Appeals for the Fourth Circuit (330 F. 2d 946), which reversed an unreported decision of the District Court for the Eastern District of Virginia.

Jurisdiction in the District Court was based on diversity of citizenship. The suit is a derivative action brought by plaintiff as a stockholder of defendant Atlantic Research Corporation ("Atlantic") against its directors for breaches of their fiduciary duties. The District Court granted defendants' motions to dismiss on the ground that the amended complaint does not comply with Rule 23(b) FRCP, in that it does not allege a demand on the board of directors of Atlantic to bring this action, or reasons for not making such demand (Scurlock pet. 21a). The Fourth Circuit reversed on the ground that the complaint alleges facts sufficient to dispense with a demand on the directors and the stockholders of Atlantic.

The questions presented to this Court by the petitions for certiorari are limited to the issue of demand on the *directors* (Sloan pet. 2; Scurlock pet. 2). No question concerning a demand on the *stockholders* is, therefore, before the Court.

QUESTION PRESENTED

Where the complaint in a stockholder's derivative action brought in the diversity jurisdiction of the District Court sets forth with particularity facts showing that each of the directors is liable for the wrongs alleged in the complaint, must the plaintiff first make a demand upon the directors before he can institute an action on behalf of the corporation?

STATEMENT OF THE CASE

1. The amended complaint.

The summary of the amended complaint ("complaint" hereinafter) set forth in the petitions bears little similarity to the allegations actually made. We must supply the omissions.

Atlantic is a corporation organized under Virginia law (par. 1(c)). The five individual defendants (Scurlock, Sloan, Johnston, Salisbury, Schoeffel) did and do constitute its entire board of directors (par. 3). Defendant Scurlock was and is Atlantic's president; defendant Sloan was and is its executive vice-president (par. 4). Scurlock and Sloan own 21% and 18%, respectively, of Atlantic's common stock. The three other individual defendants, together with their associates and families, own or control other substantial blocks of Atlantic's stock (par. 4).

The market price of Atlantic's stock has been steadily declining since June 1961 (par. 6(c)). As a consequence, the value of defendants' personal stockholdings likewise declined (par. 7).

In order to protect their own personal investments in Atlantic in the face of the falling market, defendants caused Atlantic to spend about $3,900,000 of its funds for purchases of its own stock, which were intended to support the market. The purchases were made through certain intermediaries, to whom Atlantic loaned money in return for promissory notes (pars. 8, 9). The value of the notes was substantially below $3,900,000; so were the shares purchased by Atlantic's intermediaries. The stock purchases and loans served no corporate purpose and resulted

in the diversion of Atlantic's assets from useful and productive purposes (par. 11).

Defendants permitted further diversions of Atlantic's funds. Those funds were used to finance four personal holding companies of defendant Scurlock (Pine Ridge, Texas Capital, Edsall Development, Eastern Associates) (pars. 14-17). Defendants caused Atlantic to enter into unfavorable lease arrangements with these corporations (*ibid.*).

The various diversions charged in the complaint are documented in detail in an opinion of the Securities and Exchange Commission; *Matter of Atlantic Research Corporation* (Dec. 6, 1963, Securities Act Release No. 4657). The Commission suspended trading in Atlantic's stock because of the falsity of Atlantic's published financial statements (par. 12).

After setting forth these substantive claims, the complaint alleges the reason for making no demand upon Atlantic's board of directors, as follows (par. 20):

> "20. Demand upon the board of directors of Atlantic to bring this action would be futile because:
>
> (a) The board of directors is controlled and dominated by the alleged wrongdoers, through their official positions with Atlantic, and by virtue of their very substantial stockholdings;
>
> (b) The directors have participated in the wrongs alleged;
>
> (c) The directors have negligently permitted the aforementioned wrongs to occur and are liable therefor; and

(d) The institution of this action by the directors would place it in hostile hands and would prevent its effective prosecution."

2. Other matters before the District Court.

Defendants filed neither an answer to the complaint nor any affidavits questioning the truth of its allegations. Apart from the complaint itself, only two pieces of evidence were placed before the District Court:

(a) The SEC suspended trading in Atlantic's stock on October 10, 1962. Following that event, and about simultaneously with the institution of this action, Atlantic's board took certain steps which defendants are pleased to call "corrective" or "remedial". Most glaring, however, is the board's failure to take the only action which might really have corrected the wrongs done: It brought no action against the wrongdoers. What the board did do is summarized in a Special Report to Atlantic's stockholders of November 9, 1962 (Sloan pet. 59-62):

> I. The board appointed a Finance Committee consisting of two of the wrongdoers (defendants Johnston and Sloan).
>
> II. The board retained a firm of Washington lawyers to represent Atlantic before the SEC.
>
> III. The board authorized an increase of its membership from five to seven, but failed to appoint any new directors.
>
> IV. The board appointed an Executive Committee, consisting of three of the wrongdoers (Sloan, Schoeffel, Johnston).

V. The board appointed general counsel for Atlantic.

VI. The board arranged to retain accountants.

VII. The board resolved to find, as soon as possible, a new treasurer.

VIII. Scurlock and Sloan guaranteed Atlantic's loans (Sloan pet. 54); but the financial responsibility of these two individuals is highly doubtful.*

IX. Defendant Scurlock was made chairman of the board instead of president; defendant Sloan became vice-chairman and chief executive officer; and an outsider, M. Lee Rice, became president (Sloan pet. 57-58).

None of these "corrective actions" had the slightest tendency to repair the injury defendants had inflicted upon Atlantic.

(b) The only other evidence submitted by defendants was a deposition of the plaintiff. So far as here relevant, plaintiff testified that he had no discussion with his attorney regarding a demand on the board of directors but had decided to proceed without such a demand (Sloan pet. 50-51). He received Atlantic's "Special Report" to its stockholders only after he had verified the complaint (Sloan pet. 50); he did not pay too much attention to it and did not know at his deposition whether the "remedial action" outlined in the report was the same he was requesting in his lawsuit (Sloan pet. 52).

* The Special Report to Atlantic's stockholders points out that, despite the guaranties of Scurlock and Sloan, Atlantic's accountants required the setting up of a substantial reserve against the loans.

ARGUMENT

POINT I

The Petitions Present No Question of Federal Law.

Since this Court's decision in *Swanson* v. *Traer*, 354 U. S. 114 (1957), it is elementary that, in a diversity case such as this, the necessity of a demand on the board of directors and the circumstances excusing such demand are determined by state law.

In the *Swanson* case, the District Court had dismissed the complaint on the ground "that the controversy did not fall within the exceptional group of cases where the stock holder may dispute the management and take the reins of corporate litigation in his own hands" (354 U. S., at 115). The Seventh Circuit did not reach that question but dismissed the action for lack of federal diversity jurisdiction (p. 116). This Court reversed. After rejecting the Seventh Circuit's jurisdictional ruling, it turned to the decision of the District Court and held that, in a diversity case, a stockholder's right to bring a derivative action on behalf of his corporation is governed by "local law," i.e., state law (354 U. S., at 116):

> "There remains for consideration the question ruled on by the District Court and which the Court of Appeals did not reach, viz. whether this suit is of that exceptional character which stockholders may bring.
>
> "As we stated in *Smith* v. *Sperling*, 354 U. S. 91, since our decision in *Erie R. Co.* v. *Tompkins*, 304 U. S. 64, the question whether in these diversity

> suits a stockholder may sue on behalf of his corporation is governed by local law. See *Cohen* v. *Beneficial Loan Corp.*, 337 U. S. 541, 555, 556."

The Court then quoted from *Hawes* v. *Oakland*, 104 U. S. 450, 460 (1882), the conditions under which a minority stockholder may invoke the aid of a court of equity, and proceeded to hold (354 U. S., at 447):

> "Whether local law follows that definition or adopts another and whether this case falls within the one provided by local law is a question on which the Court of Appeals has not ruled. We therefore remand the case to it for consideration of the question."

Upon remand, the Seventh Circuit held that, pursuant to the instructions given by this Court, the demand question must be determined in accordance with the laws of Illinois, under which the corporation was organized: *Swanson* v. *Traer*, 249 F. 2d 854 (Cir. 7, 1958).

Accord: *Hausman* v. *Buckley*, 299 F. 2d 696 (Cir. 2, 1962), cert. den. 369 U. S. 885; *Halprin* v. *Babbitt*, 303 F. 2d 138 (Cir. 1, 1962); *Toebelman* v. *Missouri-Kansas Pipe Line Co.*, 41 F. Supp. 334, 339-340 (D. Del., 1941), rev'd on other grounds but followed on this point, 130 F. 2d 1016, 1022 (Cir. 3, 1942); *Steinberg* v. *Hardy*, 90 F. Supp. 167, 169 (D. Conn., 1950); *Steinberg* v. *Adams*, 90 F. Supp. 604, 609 (SDNY, 1950); *Carruthers* v. *Jack Waite Mining Co.*, 14 F. R. D. 475 (SDNY, 1953); *Pomerant* v. *Clark*, 101 F. Supp. 341, 343 (D. Mass., 1951); *Carroll* v. *N. Y., N. H. & H. R. Co.*, 141 F. Supp. 456, 457 (D. Mass., 1956).

In the present case, the Fourth Circuit held that, applying the law of Virginia, a demand on Atlantic's board of directors was unnecessary (Sloan, et. 24).* This Court, we submit, will not grant certiorari to review a decision adequately based on applicable state law.

POINT II

The Decision Below Presents No Question of General or National Interest.

Whether based on federal or state law, the interlocutory decision rendered by the Court below presents no question of broad or general interest. The decision simply turns on a narrow question of pleading. The Court found that, under the particular facts here alleged, demand on the directors was excused. Other complaints in other cases will present different facts. They will have to be determined on their own merits, and the decision here will be of little, if any, value as a precedent.

It is too elementary for argument that a demand on the directors is unnecessary if all the board members participated in the wrongs complained of. Contrary to petitioners' assertion, the complaint does not just make conclusory charges of non-feasance against some of the directors. On the contrary, it alleges that each of the five defendant directors held substantial amounts of Atlantic's stock and that each of them caused Atlantic to spend $3,900,000 in order to protect their private investments by supporting the declining market. These are clear aver-

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*The Fourth Circuit further held that demand was also excused as a matter of federal law (*ibid.*).

ments of affirmative wrongdoing, which are not open to the criticism of being bare conclusions. It is, therefore, hardly necessary to add that, "Whether these charges be called 'allegations of fact' or 'mere conclusions of the pleader', * * * they must be taken into account in deciding whether [plaintiff] is entitled to have [his] case tried": *United States* v. *Employing Plasterers Ass'n*, 347 U. S. 186, 188 (1954); *Brown* v. *Bullock*, 194 F. Supp. 207, 228 (SDNY, 1961), aff'd 294 F. 2d 415 (Cir. 2, 1961).

Defendants' contention that the decision below "would nullify and destroy the usefulness of Rule 23(b)" is far-fetched, indeed. It is defendants who would emasculate the Rule. Rule 23(b) expressly permits an alternative to the allegation of demand on the directors; the plaintiff may, instead, allege "the reasons for not making such effort". Defendants would read the second alternative out of the Rule. It is difficult to conceive of reasons excusing a demand that are more cogent and persuasive than the participation of all incumbent directors in the wrongs alleged. See *Lecitt* v. *Johnson*, CCH Fed. Sec. Law Reporter, Sec. 91413, p. 94641-2 (Cir. 1, Op. No. 6249, July 8, 1964, not yet otherwise reported).

Petitioners would ascribe to the District Court a finding that Atlantic's board has "an independent and disinterested majority" (Sloan pet. 5). The record contains no such finding* nor any evidence which would support it. On

* In the part of its decision cited by petitioners, the District Court merely held that it was reasonable to speculate—"and it is only speculation"—that the board might have acceded to a demand by plaintiff (Sloan pet. 40). This is a far cry from a finding that the board had an independent and disinterested majority.

the contrary, the allegation of the complaint that all directors participated in the breach of duty stands undenied. It would be absurd to expect the guilty directors to sue themselves. If they did, it would be a mockery of justice to place them in charge of the action.

Defendants pretend to find fault with plaintiff because he did not discuss the demand question with his lawyer. They fail to say why such discussion was necessary when the futility of a demand was so obvious. In any event, the necessity or excuse of a demand depends on its futility, not on the conversations or mental operations of plaintiff and his lawyer.

Equally irrelevant is plaintiff's failure, at his deposition, to remember the details of defendants' so-called "remedial action" set forth in Atlantic's report to its stockholders. As stated, plaintiff received the report *after* he had verified the complaint (Sloan pet. 50). Even had he received it earlier and given it close study, he could have found in it no more than that the "remedial action" was a sham and that the directors, fully apprised of the facts, did not see fit to bring an action, which they would not have been qualified to prosecute in any event.

All these minutiae of evidence were fully considered by the Court below. They are peculiar to this case; none of them is likely to recur in other cases; there exists no warrant for their review by this Court.

POINT III

The Decision Below Is Not in Conflict With Other Authorities.

Defendants assert (Sloan pet. 17-19) that the decision below is in conflict with *Squair* v. *Lookout Mountain Co.*, 42 Fed. 729, 732-3 (E. D. Tenn., 1890); *Watson* v. *United States Sugar Refinery*, 68 Fed. 769, 773 (Cir. 9, 1895); *Ziegler* v. *Lake St. Elev. R. Co.*, 76 Fed. 662, 663 (Cir. 7, 1896); *Shimer* v. *Milton Mfg. Co.*, 10 F. Supp. 943 (M. D. Pa., 1935); *Guth* v. *Groves*, 44 F. Supp. 851 (SDNY, 1942); and *Levitan* v. *Stout*, 97 F. Supp. 105, 114-5 (W. D. Ky., 1951). We submit that none of these cases is pertinent.

The first three (*Squair*, *Watson* and *Ziegler*) were decided prior to the turn of the century under the then effective Equity Rule 94 (104 U. S. IX). While Equity Rule 94 was the predecessor of the present Rule 23(b) FRCP, it differed from the present Rule in a decisive respect: The requirement of a demand on the directors was absolute. Equity Rule 94 did not permit the complaint to allege "the reasons for not making such effort". This alternative clause was added to the Rule in 1912, when it became Equity Rule 27 (226 U. S. 656). The pre-1912 decisions in the *Squair*, *Watson* and *Ziegler* cases are, therefore, obsolete; and they have never been cited with approval by a federal court since 1912.* It is, therefore, unnecessary to point out the sharp factual differences between those cases and that at bar, as well as the fact that none of them involved Virginia law.

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* The *Watson* case was mentioned in *Tower Hill-Connellsville Coke Co.* v. *Piedmont Coal Co.*, 64 F. 2d 817, 825, fn. 1 (Cir. 4, 1933), as one of many cases relied upon by the appellant, which the court found not to be controlling.

Equally inapposite are the three other cases cited by defendants. In *Shimer, supra* (10 F. Supp., at 944), the compiaint merely alleged that the directors were "hostile to the minority interests of stockholders and perform and execute their respective offices and functions in an autocratic, unreasonable and selfish manner". This falls far short of an allegation, such as that made by the present complaint, that the directors participated in the wrongs complained of. The complaint in *Guth, supra* (44 F. Supp., at 854), did charge the directors with complicity, but the court found the charge refuted by the record since the defendants had not been directors at the relevant times. The same was true in *Leviton, supra* (97 F. Supp., at 114-5).

CONCLUSION

It is respectfully submitted that the petitions for certiorari should be denied.

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Dated: August 20, 1964.

FILED
11 1964
CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1964

No. 326

ARTHUR W. SLOAN, FRANKLIN C. SALISBURY, AND ATLANTIC RESEARCH CORPORATION,
Petitioners,

v.

SAMUEL MELTZER, *Respondent*

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY TO RESPONDENT'S BRIEF

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INDEX

Table of Authorities

Cases:

	Page
Levitt v. *Johnson*, CCH Fed. Sec. Law Reporter, Sec. 91413, P. 94641 (6 Cir., Op. No. 6249, July 8, 1964, not yet officially reported)	4
Smith v. *Sperling*, 354 U.S. 91	5
Swanson v. *Traer*, 354 U.S. 114	5

Statutes and Regulations:

Federal Rules of Civil Procedure—Rule 23(b)	3, 3, 4, 4, 5, 5, 6, 6, 6, 7

Administrative Decisions:

Matter of Atlantic Research Corporation (SEC, Dec. 6, 1963, Securities Act Release No. 4657)	1, 2, 3

IN THE

SUPREME COURT OF THE UNITED STATES

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SAMUEL MELTZER, *Respondent*

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY TO RESPONDENT'S BRIEF

Respondent relies on the opinion of the Securities and Exchange Commission (SEC) in *Matter of Atlantic Research Corporation* (Dec. 6, 1963, Securities Act Release No. 4657) in support of his position. It should be noted that the SEC opinion was based upon an *ex parte* "private investigation"— a one-sided record with no opportunity to Atlantic to know what was in the record, to cross examine witnesses or to submit rebuttal evidence.

The SEC opinion was issued approximately twelve months after the filing of the amended complaint. Those findings, though issued in December, 1963, pertain to a

registration statement for 179,000 shares of Atlantic's 2,000,000 issued shares, and generally are addressed to facts existing in July, 1962 and prior to that date—not to facts existing after the SEC began its investigation in August of 1962. The SEC made no finding that all of the Board members were wrongdoers in support of Respondent's contention that a demand on the Board would therefore be futile. The SEC confined its opinion to the alleged wrongdoings of Petitioner, Scurlock. It did not criticize Sloan or the other Board members named by Respondent in his complaint.

As was pointed out in the Petition for Certiorari of Petitioners Sloan, Salisbury and Atlantic, ("Sloan Petition"), Dr. Scurlock was removed in 1962 from his position as President and Chief Executive Officer of the Corporation. (SEC Opinion, page 6.) Dr. Scurlock is not now President of Atlantic as alleged by Respondent in his complaint and brief. (Respondent's Brief, page 3.) Furthermore, the five Petitioners (Scurlock, Sloan, Johnston, Salisbury and Schoeffel) do not now constitute the entire Board of Directors. (Respondent's Brief, page 3.) Two new outside directors were elected (Sloan Petition, Appendix F, page 60) contrary to Respondent's assertion that the Board "failed to appoint any new directors." (Respondent's Brief, page 5.)

It should also be pointed out that the $3,900,000 figure which Respondent alleges was divested from Atlantic by Dr. Scurlock is not found anywhere in the SEC Opinion. The SEC found in its Opinion after the "private investigation", that ARC loaned Pine Ridge Corporation a total of $556,937 (SEC Opinion, page 9) and Texas Capital Investments, Inc., a total of $1,215,000 (SEC Opinion, page 15).

Respondent also implies that the guarantee of Petitioners, Sloan and Scurlock is questionable because "the financial responsibility of these two individuals is highly doubtful". (Respondent's Brief, page 6). The reserve set up against the loans referred to by Respondent in his brief (page 6) was eliminated after Drs. Scurlock and Sloan reaffirmed the guarantee. (SEC Opinion, page 17). This fact disproves this claim of Respondent.

Without pointing out all the other erroneous statements made by Respondent in his brief and complaint, Petitioners urge that the mistakes of fact cited prove the wisdom of Rule 23(b). They prove the value of that Rule's requirement that a stockholder go to the Board of Directors for corrective action before coming into court. If Respondent went to that Board as the District Court required, he would soon know of these and other errors of fact and perhaps find that the Board, as suggested by the District Court, had taken all the corrective action he seeks. (Sloan's Petition, Appendix B, page 40).

Petitioners reiterate again that this case was not decided merely on the allegations in the complaint. As the record shows, extensive depositions—ignored by the Court of Appeals—prove conclusively that Respondent did not even consider compliance with Rule 23(b) in his rush to file his original complaint.

Contrary to Respondent's contention that state law determines whether a demand must be made on a board of directors prior to bringing a derivative action, (Respondent's Brief, pages 7-9) the Fourth Circuit declared in its decision:

> "The necessity and sufficiency of the preliminary demand upon the directors, and the circumstances which

> satisfies omission of such demand, under Rule 23(b) would seem to be procedural in nature and hence governed by Federal law. (citations omitted) (Sloan Petition, Appendix A, page 24).

The Fourth Circuit merely declared that "Virginia decisional law appears to be in accord." (Sloan Petition, Appendix A, page 24).

Respondent cites cases which merely emphasize the conflict and confusion which exists over Rule 23(b) due to the Fourth Circuit's opinion. Respondent cites the case of *Levitt* v. *Johnson*, CCH Fed. Sec. Law Reporter, Sec. 91413, p. 94641-2 (Cir. 1, Op. No. 6249, July 8, 1964, not yet otherwise reported) in support of his contention that a demand on the Board of Directors was excusable (Respondent's Brief, page 10). It should be noted, however, that the question before the Court in *Levitt* was not whether a preliminary demand should have been made upon the Board of Directors, but rather *should a demand have been made upon the stockholders* before bringing a derivative action. Clearly, the two demands are vastly different, as sending a demand for corrective action to thousands of stockholders is more difficult than sending it to seven directors. The Court's holding that a demand upon *the stockholders* would have been burdensome and therefore not required makes the conflict among the circuits on this issue more apparent. (See Sloan Petition, page 18). The need for clarification of Rule 23(b) by this Court is all the more urgent. The First Circuit in *Levitt* did hold as did the Fourth Circuit in the case at bar that state law does not govern the adequacy of an excuse for failure to make a demand for corrective action on the

Board of Directors or stockholders. This is directly contrary to Respondent's contention. (Respondent's Brief, pages 7-9).

Respondent relies on the companion cases of *Swanson* v. *Traer*, 354 U.S. 114 and *Smith* v. *Sperling*, 354 U.S. 91 in further support of his argument. It should be noted, however, that in *Swanson*, the question before this Court was solely Federal diversity jurisdiction and the proper alignment of parties to a derivative action. In *Sperling*, this Court was also confronted with the question of proper alignment of parties. Unlike the case at bar, in *Sperling*, a demand had been made on the Board of Directors and was refused. This Court held, therefore, that the corporation was properly made a defendant. In neither of these cases was this Court confronted with the issue raised by Petitioners here—the proper interpretation and effectiveness of Rule 23(b).

Almost two years have elapsed since the filing of the original complaint in November, 1962. It is obvious that in two years many things are bound to have happened which are all the more reason to require Respondent to make his demand for corrective action upon Atlantic's Board of Directors. Changes that have occurred within Atlantic since the filing of the original complaint could well satisfy any demand he may wish to make and render resort to court action unnecessary—the very purpose of Rule 23(b).

That the purpose of the Rule was to provide a remedy before the agency best equipped by information, experience and power to take appropriate action to cure stockholder complaints, cannot be denied. The avoidance of court trials of corporate matters where directors could straighten them

out to stockholder satisfaction, and thus avoid litigation, is a purpose this Court should not allow to be frustrated. It is preposterous to assume that after two years, during which it is obvious that two stockholders' meetings and many Board meetings have been held, nothing has been done about the problems mentioned in the complaint. It would do violence to the text, as well as the purpose, of Rule 23(b) to force the District Court, instead of the Directors, to act in this case—the very type of case which the Rule was intended to cover.

Respondent has made some shocking allegations against Petitioners and at this stage of this lawsuit Petitioner cannot refute them because in testing the complaint under our jurisprudence they must be assumed to be true. But, Rule 23(b) does not say it is applicable only to "good" men and inapplicable to "bad" men. It applies to all men. It says in plain language that the administrative remedy there provided must be exhausted before a stockholder can bring his complaint into court. Respondent did not exhaust his administrative remedy—he ignored it. His complaint must be dismissed or the Rule becomes worthless because under the Fourth Circuit's decision any stockholder who makes his allegations shocking enough, and accuses the entire membership of a Board of Directors of wrongdoing, can get into a court without going to the Board of Directors first.

It is overwhelmingly evident under all the facts and circumstances as to potential stockholder litigation, that this is a case of national importance which should be reviewed and reversed by this Court. The Fourth Circuit's decision will at best allow every stockholder with an uncontrollable option to nullify the effectiveness of Rule 23(b). Clearly, the Federal courts will be flooded by the

very stockholder litigation which Rule 23(b) was intended to prevent.

Respectfully submitted,

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